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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1932

No. 434

THE UNITED STATES, PETITIONER

vs.

DAKOTA-MONTANA OIL COMPANY

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED OCTOBER 5, 1932
CERTIORARI GRANTED NOVEMBER 14, 1932

(37131)

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1 In Court of Claims of the United States

No. L–413

DAKOTA-MONTANA OIL COMPANY

vs.

THE UNITED STATES

I. *History of proceedings*

On October 9, 1930, the plaintiff filed its original petition.

On November 18, 1930, the defendant filed a general traverse to said petition.

On March 19, 1931, by leave of court, the plaintiff filed an amended petition, which is as follows:

II. *Amended petition*

Filed March 19, 1931

To the Honorable the Court of Claims:

The plaintiff, the Dakota-Montana Oil Company, respectfully represents:

I. That it now is and during all the times herein mentioned was a corporation duly organized, existing, and doing business under and by virtue of the laws of the State of North Dakota; that prior to the 4th day of February, 1928, its principal place of business was located in Kenmare, North Dakota, and since said date its principal place of business has been and now is located at Shelby, Montana; that at all times pertinent hereto plaintiff has been and now is engaged in the business of developing oil properties and producing crude oil, including the owning, developing, and operating of oil properties, procuring leases on oil lands, drilling, owning, and operating oil wells, and the building, erecting, constructing, and owning the necessary camps and equipment for the operation of oil wells.

II. That during the calendar year of 1926 plaintiff kept its books and made its income-tax returns on a calendar-year and an
2 accrual basis; that during the calendar year ending December 31, 1926, plaintiff had a gross income from its oil-well operations of $575,160.65, and other income of $3,670.24, making a total gross income of $578,830.89. During said year plaintiff had allowable deductions from income of $94,698.84, exclusive of depletion and depreciation. That 27½ per cent of $575,160.65, which was its gross income from oil operations during said calendar year of 1926, computed for depletion in accordance with section 204 (c) (2) of the revenue act of 1926, is the sum of $158,169.18.

III. That prior to the calendar year ending December 31, 1925, plaintiff expended in the development and construction of oil wells on its properties, including therein the expenses and cost of drilling oil wells, casing the same, erecting derricks, camps, and equipment for the operation of such oil wells, and for all items of expense in the drilling, construction, and completion of a completed oil well ready to connect the same to a pipe line, the sum of $38,594.83.

IV. During the calendar year ending December 31, 1925, plaintiff expended in such oil-well development and construction expenses, as above set forth, the sum of $36,372.47, making an aggregate investment in such expenses during said year of the sum of $74,967.30; that during said calendar year ending December 31, 1925, there was a total oil reserve upon the properties owned by plaintiff upon which said oil-well construction and development investment had been expended of 425,000 barrels, of which amount plaintiff extracted and produced during said year 27,226.67 barrels; that a just and reasonable depreciation of said investment in oil-well
3 development and construction expense for said calendar year ending December 31, 1925, is the sum of $4,802.55, leaving at the beginning of said calendar year ending December 31, 1926, a depreciable investment in said oil-well development and construction cost of $70,164.75. During said calendar year ending December 31, 1926, plaintiff expended in such oil-well development and construction expense the sum of $97,614.77, making a total depreciable investment in said oil-well development and construction expense existing in said calendar year ending December 31, 1926, of $167,779.57.

V. At the beginning of said calendar year ending December 31, 1926, there was an oil reserve of 397,773.33 barrels on said properties upon which plaintiff herein had made said oil-well development and construction investment as aforesaid, and during said year there was added to said oil reserve 427,480 barrels upon property which plaintiff had expended its investment for such oil-well development and construction expense, making an aggregate oil reserve upon such property for said calendar year ending December 31, 1926, of 825,253.35 barrels. During said calendar year plaintiff extracted and produced 641,569.59 barrels of oil from said oil reserves. That a just and reasonable depreciation upon said oil-well development and construction expense for said calendar year ending December 31, 1926, is the sum of $130,440.87.

VI. All of said expenses and expenditures so made by plaintiff herein for said oil-well development and construction expenses prior to and during said calendar year ending December 31, 1925, and during said calendar year ending December 31, 1926, were capitalized by plaintiff and charged to invested capital.

4 VII. That at the time required by law plaintiff duly filed with the appropriate collector of internal revenue its income-tax return for said calendar year ending December 31, 1926. Said

return showed a tax of $42,082.31, which sum plaintiff duly paid to the appropriate collector of internal revenue on the dates as follows:

March 11, 1927	$10,520.58
Sept. 10, 1927	10,520.58
Sept. 16, 1927	10,520.58
Dec. 10, 1927	10,520.57

VIII. Plaintiff is informed and believes, and therefore avers, that said sums have been duly turned into and deposited by defendant in the Treasury of the United States.

IX. Said tax return for the calendar year ending December 31, 1926, so filed as aforesaid by plaintiff herein, was prepared and filed by plaintiff upon what it then understood was the basis required by the applicable laws of the United States, and plaintiff therein claimed a deduction for depletion of $159,200.71, and a deduction for depreciation of $13,210.58, said depreciation being calculated upon the probable life of the buildings, structures, equipment, etc., without regard to the extent of the oil reserves, the amount of extraction or production during the calendar year, and the probable life of such reserve and oil properties; that on the 2d day of May, 1928, plaintiff filed with the appropriate collector of internal revenue an amended tax return for the calendar year ending December 31, 1926, said amended return being prepared in accord with what it then understood and was advised were the requirements of the applicable laws of the United States. Said amended return showed a tax of $21,959.24, and claimed a deduction for depletion of $158,169.18 and a deduction for depreciation of $163,301.81. Said deduction for depreciation was calculated upon the basis of the depreciable investment in oil-well development and construction costs, as above set out, upon the proportion of extraction of the oil reserves from the properties upon which said investments were made.

X. On the 2d day of May, 1928, plaintiff duly filed with the appropriate collector of internal revenue a claim for refund of the sum of $20,123.07, or such greater amount as is legally refundable, of the income tax paid by it for the calendar year ending December 31, 1926. Said claim for refund was based upon a claim for a deduction for depreciation of $163,301.81, as set forth in said amended income-tax return for said year so filed by plaintiff as aforesaid.

XI. Said claim for refund was duly rejected by the defendant herein by letter to plaintiff dated March 6, 1929.

XII. Said defendant still retains said sum of $42,082.31; and has wholly failed to refund or pay to plaintiff said sum or any part thereof.

XIII. That by reason of the facts above set forth the defendant has erroneously, illegally, and contrary to the provisions of the internal revenue laws assessed, levied and collected from plaintiff herein said sum of $42,082.31, and that by reason of the aforesaid facts there is now due and owing to plaintiff from defendant herein said sum of

$42,082.31, together with interest thereon as provided and required by law.

XIV. No other action has been had on said claim in Con-
6 gress or by any of the departments; no person other than the plaintiff is the owner thereof or interested therein; no assignment or transfer of this claim, or of any part thereof or interest therein, has been made; the plaintiff is justly entitled to the amount herein claimed from the United States, after allowing all just credits and offsets; the plaintiff has at all times borne true allegiance to the Government of the United States and has not in any way voluntarily aided, abetted, or given encouragement to rebellion against the said Government. The plaintiff is a citizen of the United States.

XV. Whereby plaintiff prays for judgment against defendant herein for the sum of $42,082.31, together with interest thereon as provided by law, and all such other remedy and relief as the court may deem proper and just.

Respectfully submitted,

KING & KING,
Attorneys for Plaintiff.

LOUIS P. DONOVAN,
Of Counsel.

[*Duly sworn to by Herman J. Galloway; jurat omitted in printing.*]

7 III. *General traverse*

Filed April 28, 1931

And now comes the Attorney General, on behalf of the United States, and answering the amended petition of the claimant herein, denies each and every allegation therein contained, and asks judgment that the amended petition be dismissed.

CHARLES B. RUGG,
Assistant Attorney General.

IV. *Argued and submitted on merits*

On May 9, 1932, this case was argued and submitted on merits by Mr. Herman J. Galloway, for the plaintiff, and by Mr. Assistant Attorney General Charles B. Rugg, for the defendant.

8 V. *Special findings of fact, conclusion of law, and opinion of the court, by Williams, J.; dissenting opinion by Littleton, J., and dissenting opinion by Green, J.*

Filed July 5, 1932

Mr. Herman J. Galloway for plaintiff. Messrs. King & King and Louis P. Donovan were on the brief.

Mr. Assistant Attorney General Charles B. Rugg for defendant. Messrs. Ralph C. Williamson and T. H. Lewis, jr., were on the brief.

This case having been heard by the Court of Claims, the court, upon the report of a commissioner, and the evidence, makes the following

Special findings of fact

1. On January 1, 1926, plaintiff was, and ever since that date has been, and now is, a corporation duly organized and doing business under the laws of the State of North Dakota. All during said time prior to February 4, 1928, plaintiff's principal place of business was located at Kenmare, North Dakota, and since that time its principal place of business has been located at Shelby, Montana. At all times pertinent hereto plaintiff has been and now is engaged in the business of developing and operating oil properties and producing crude oil, including the owning, development, and operation of oil properties, procuring leases on oil lands, drilling, owning, and operating oil wells, and building, erecting, constructing, and owning the necessary camps and equipment for the construction and operation of said wells.

2. During the calendar year of 1926 plaintiff kept its books and made its income-tax returns on a calendar year and an accrual basis.

3. During the calendar year ending December 31, 1926, plaintiff had a gross income from its oil-well operations of $575,160.65 and other income of $3,670.24, making a total gross income of $578,830.89. Twenty-seven and one-half per cent of $575,160.65, which was plaintiff's gross income from oil-well operations during the calendar year of 1926, computed for depletion in accordance with the provisions of section 204 (c) (2) of the revenue act of 1926, is the sum of $158,169.18.

4. During the calendar years ending December 31, 1923, December 31, 1924, December 31, 1925, and December 31, 1926, plaintiff
9 expended on its properties known as the Emmons lease, for labor, fuel, hauling, freight, supplies, material, and equipment used in drilling oil wells, casing the same, erecting derricks and camps, and equipment for the operation of such wells, and for all items of cost in the drilling and completion of producing oil wells ready to connect the same to a pipe line, the sum of $167,779.52, which sum is divided as follows:

Calendar year	Cost of equipment and materials	Cost of freight, hauling, installing equipment, and materials	Total cost of equipment and materials	Total cost of drilling (labor, fuel, etc.)	Total cost of development
1923	$1,947.98	$671.60	$2,618.98	$20,738.28	$23,357.26
1924	889.61	489.75	1,379.36	13,858.21	15,237.57
1925	11,048.17	2,181.77	13,229.94	18,339.98	31,569.92
1926	48,690.13	6,748.82	55,438.95	42,175.82	97,614.77

This made a total expenditure on the Emmons lease for the oil-well equipment and materials of $72,667.23 and in drilling $95,112.29.

5. During the calendar year ending December 31, 1925, the plaintiff's fractional share of the estimated oil recoverable from the property known as the Emmons lease owned by plaintiff, and upon which the aforesaid expenditures had been made, was 425,000 barrels. Plaintiff's fractional share of the oil which it extracted and produced during the calendar year 1925 from said Emmons lease was 27,226.67 barrels.

6. At the beginning of the calendar year ending December 31, 1926, the plaintiff's share of the total oil reserves estimated to be remaining in the property known as the Emmons lease, owned by plaintiff, and upon which the aforesaid expenditures had been made, was 397,773.33 barrels, and during said year there was added to the plaintiff's share of the estimated oil reserves in the Emmons lease 427,480 barrels not previously known to exist, making an aggregate estimated oil reserve owned by plaintiff in the Emmons lease for the calendar year ending December 31, 1926, of 825,253.33 barrels. During the calendar year ending December 31, 1926, plaintiff's fractional share of the oil extracted and produced by it from the properties known as the Emmons lease was 641,596.59 barrels of oil.

7. During the calendar year ending December 31, 1926, plaintiff expended on its properties known as the Carlson-State lease for labor, fuel, hauling, freight, supplies, material, and equipment used in the drilling of oil wells, casing the same, erecting derricks, camps, and equipment for the operation of such oil wells and for all items of cost in the drilling and completion of producing oil wells ready to connect the same to a pipe line the sum of $33,912.10, which sum is divided as follows:

Equipment and materials	$16,915.31
Freight and hauling	2,344.59
Total cost of equipment and materials	19,259.90
Total cost of drilling (labor, fuel, etc.)	14,652.20

10 During the calendar year ending December 31, 1926, plaintiff's fractional share of the estimated total oil reserve in the said Carlson-State lease was 639,360 barrels. Plaintiff's fractional share of the oil extracted and produced by it during the year 1926 from the Carlson-State lease was 535.58 barrels.

8. All expenditures above set forth so made by plaintiff herein prior to and during the calendar year ending December 31, 1925, and during the calendar year ending December 31, 1926, were capitalized by plaintiff and included in its invested capital. The productive life of all producing wells, the expenditures for which were capitalized as above set forth, was more than one year.

9. At the time required by law, plaintiff duly filed with the appropriate collector of internal revenue its income-tax return for the calendar year ending December 31, 1926, which return showed a tax

of $42,082.30, which sum plaintiff duly paid to the appropriate collector of internal revenue on the dates as follows:

March 14, 1927	$10,520.58
June 14, 1927	10,520.57
September 12, 1927	10,520.58
December 12, 1927	10,520.57

The said sums have been duly turned into and deposited by the defendant in the Treasury of the United States.

10. In the tax return for the calendar year ending December 31, 1926, plaintiff claimed a deduction for depletion of $159,200.71, and a deduction for depreciation of $13,210.58, upon certain camp buildings and lease equipment. On May 2, 1928, plaintiff filed with the appropriate collector of internal revenue an amended tax return for the calendar year ending December 31, 1926. Said amended return showed a tax of $21,959.24, and claimed a deduction for depletion of $158,169.24, and claimed a deduction for depreciation of $163,301.81, as follows:

Depreciation on well equipment and on intangible drilling costs	$130,469.28
Depreciation on camp buildings and lease equipment	26,529.95
Depreciation on preliminary development	6,302.58

Said deduction for depreciation was calculated as shown on a schedule designated as Schedule #20 attached by plaintiff to the said amended tax return, a copy of which is in evidence as Exhibit A.

11. On May 2, 1928, plaintiff duly filed with the appropriate collector of internal revenue a claim for refund of the sum of $20,123.07, or such greater amount as is legally refundable, of the income tax paid by it for the calendar year ending December 31, 1926, together with interest thereon. A photostat copy of this claim for refund is in evidence as Exhibit B.

12. Defendant herein by letter to plaintiff dated March 6, 1929, rejected the claim for refund with the exception of an overassessment in the sum of $1,658.86, as hereafter set out. The defendant still retains the sum of $20,123.07 and has not refunded or paid to plaintiff said sum or any part thereof. The defendant on or about April 30, 1929, offered plaintiff herein a check for $1,787.64, being said overassessment of $1,658.86, together with 128.78, interest thereon, which sum plaintiff refused to accept and returned the check.

11 13. Of the deduction claimed for depreciation in the 1926 amended return, the following amounts are stipulated as allowable:

Depreciation on camp building, etc., as claimed		$26,529.95
Depreciation on well equipment and material, computed on the unit of production basis:		
Emmons lease	$50,069.56	
Carlson-State lease	14.52	
		50,084.08
Total depreciation		76,614.03

Of this sum there was allowed, at time plaintiff paid its said tax, depreciation of $13,210.58 on camp building, etc., leaving an addi-

tional depreciation allowable for the calendar year 1926 in the amount of $63,403.45.

14. Assuming that the amounts expended as drilling costs are returnable through depletion, no further deduction on this item is allowable to the plaintiff for the calendar year 1926.

Assuming that the amounts expended as drilling costs are returnable through depreciation, the plaintiff is entitled to a further deduction for the calendar year 1926, calculated upon the proportion of the oil reserve extracted during the calendar year, as follows:

Emmons lease	$71,308.93
Carlson-State lease	12.28
	71,321.21

15. During the calendar years 1922, 1923, and 1924 plaintiff had charged as operating expenses certain expenditures made by it in the sum of $18,907.74. These expenditures were early and preliminary costs incident to the leases and preliminary to the drilling, construction, and completion of oil wells. Defendant required plaintiff to set up said expenditures in its tax returns as capital investments, and the defendant has accordingly increased plaintiff's capital investments for the calendar year 1926 in the amount of $18,907.74. A statement of the expenditures is as follows:

Year ending Dec. 31, 1922:		
Expenses	$8,798.66	
Depreciation on equipment	141.36	
Depreciation on furniture and fixtures	19.93	
		$8,959.95
Year ending Dec. 31, 1923:		
Expenses	6,778.10	
Depreciation on equipment	631.28	
Depreciation on furniture and fixtures	60.12	
		7,469.50
Year ending Dec. 31, 1924:		
Expenses	1,890.60	
Royalties	1,669.30	
Interest and taxes	717.11	
Depreciation on equipment	1,171.91	
Depreciation on furniture and fixtures	80.37	
Total	5,529.29	
Less: Receipts	3,051.00	
		2,478.29
Total		18,907.74

12 Assuming that the said amount of $18,907.74 is returnable through depletion, no further deduction on this item is allowable to the plaintiff for the calendar year 1926.

Assuming that the plaintiff is entitled to a deduction for depreciation upon said expenditures for the calendar year 1926 on the unit of production basis, it should be allowed a deduction of $7,759.63.

16. Plaintiff in its original income-tax return for the calendar year 1926 claimed a deduction for depreciation on camp buildings and lease equipment other than that included in the foregoing

findings in the sum of $13,210.58, but in its amended return for said year and its claim for refund plaintiff claimed a deduction for depreciation on these items in the sum of $26,529.95. The Commissioner of Internal Revenue in acting upon said claim for refund allowed a deduction on account of depreciation upon the equipment in the amount of $26,529.95 and, as hereinabove set out, offered plaintiff a check for the sum of $1,658.86 principal and $128.78 interest as a refund thereon, which check was returned to defendant by plaintiff.

17. If the amounts expended as drilling costs are returnable through depletion and no part thereof through depreciation, then plaintiff is entitled to recover herein from defendant because of the $76,614.03 depreciation on camp buildings, well equipment, and material as set forth in finding 13, the sum of $8,420.21.

If of the drilling costs the sum of $71,321.21 as set forth in finding 14 is returnable through depreciation, then plaintiff is entitled to recover herein from defendant the sum of $18,048.57.

If of the drilling costs the sum of $71,321.21 as set forth in finding 14 is returnable through depreciation and the cost of $18,907.74 set forth in finding 15 is also returnable through depreciation, then plaintiff is entitled to recover herein from defendant the sum of $19,096.12.

Conclusion of law

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides as a conclusion of law that the plaintiff is entitled to recover $19,096.12, with interest.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of nineteen thousand ninety-six dollars and twelve cents ($19,096.12), with interest at the rate of six per cent per annum, from the dates of payments thereof to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of subsection (b), section 177 of the Judicial Code, being a part of the revenue act of May, 1928.

Opinion

WILLIAMS, Judge, delivered the opinion of the court:

The plaintiff corporation during the years 1923, 1924, 1925, and 1926, was engaged in the business of developing and operating oil properties and the production of crude oil, including the owning, development, and operating oil properties, procuring leases on oil lands, drilling owning, and operating oil wells, and building,
13 erecting, constructing, and owning the necessary camps and equipment for the construction and operation of such oil wells.

During the calendar years before stated the plaintiff expended upon the properties involved in suit, for labor, fuel, hauling, freight, supplies, materials, and equipment used in drilling oil wells, casing

the same, erecting derricks and camps, and equipment for the operation of such oil wells, and for all items of cost in the drilling and completion of producing oil wells, a large sum of money.

All these expenditures were capitalized by the plaintiff and included in its invested capital.

In its income-tax return for the calendar year 1926, made upon the accrual basis, in accordance with its bookkeeping methods, the plaintiff claimed a deduction for depletion of its oil reserves in the sum of $159,200.71, and claimed a deduction for depreciation of $13,210.58 upon certain camp buildings and lease equipment, and paid the tax computed upon this basis. Subsequently the plaintiff filed its amended tax return for the year 1926, in which return it claimed a deduction of $26,529.95 upon the camp buildings and lease equipment, upon which it had only claimed a deduction of $13,210.58 in its original return, and in addition thereto claimed a further deduction of $6,302.58 upon the costs of the preliminary development of its wells, and a deduction of $130,469.28 for depreciation upon its well equipment and on its intangible drilling costs. The amended return claimed a deduction for depletion in the sum of $158,169.24.

The plaintiff filed with the amended return a claim for a refund of the sum of $20,123.07, which claim was rejected with the exception of $1,658.86, an overpayment resulting from the commissioner's allowance of the increased depreciation claimed by the plaintiff in its amended return, upon the camp buildings and lease equipment. A check for the amount of this determined overassessment, with interest, was tendered to the plaintiff, which sum the plaintiff refused to accept, returning the check.

It is conceded by the Government that the cost of labor, fuel, hauling, freight, supplies, material, and equipment used in casing the oil wells, erecting camps, and equipment for the operation of such wells, are costs upon which depreciation may be had, but it contends that the actual costs of drilling the well, that is, the costs of putting the drill hole in the ground, are covered by the allowance for depletion, and are not allowable deductions for depreciation.

It is urged that the costs of drilling the well were not expended for or related in any way to the installation or erection of any tangible property; that the drill hole is not a part of the physical property constituting a completed and operating oil well, in the sense that the casings, derricks, camp buildings, and other equipment constitute such physical property; that the cost of drilling the hole is a part of the cost of the oil just as the bonus paid for a lease is a part of the oil cost, the value of the drill hole disappearing entirely when the oil reserves are exhausted. Upon these premises it is contended the costs of drilling the wells should be considered as a part of the cost of the oil itself, recoverable only through depletion.

The applicable provisions of the revenue act of 1926 (ch. 27, 44 Stat. 9, 16, 41) read:

14 "SEC. 240 (c) (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. * * *."

"SEC. 234 (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * *

"(8) In case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary * * *."

The statute expressly provides that in the case of oil wells a deduction shall be allowed both for depletion and for depreciation, the allowance to be made under rules and regulations prescribed by the commissioner and approved by the Secretary. Article 221, of Regulations 69,[1] following the provisions of section 204 (c) (2) of the 1926 act provides for the depletion deduction a taxpayer is entitled to make for the taxable year. Article 223 of the same Regulations provides that such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines and development of the property, may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. It is provided, however, that if in the exercise of this option a taxpayer charges these incidental expenses to capital account, as the plaintiff did in this case, " in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation."

Article 225 of the regulations[2] deals with depreciation of improvements in the case of oil and gas wells, and provides that owners and lessees operating oil properties will, in addition to and apart from the deduction allowable for depletion, be permitted to deduct

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[1] Treasury Regulations 69, Revenue Act of 1926:

"ART. 221. DEPLETION IN THE CASE OF OIL AND GAS WELLS.—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

[2] "ART. 225. DEPRECIATION OF IMPROVEMENTS IN THE CASE OF OIL AND GAS WELLS.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit."

a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223.

15 The precise question presented was considered by the Board of Tax Appeals in the case of Jergins Trust v. Commissioner, 22 B. T. A. 551. The board said:

"Section 234 (a) (9) of the revenue act of 1921 and section 234 (a) (8) of the revenue act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements, * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. (United States v. Ludey, 274 U. S. 295.) The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves. * * * The stipulation shows that the commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment, and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs, and hauling 'in connection with development and drilling.' This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures."

The board followed the same ruling in Ziegler et al. v. Commissioner (23 B. T. A. 1091), petroleum Exploration v. Commissioner (23 B. T. A. 890), and P-M-K. Petroleum Company v. Commissioner (24 B. T. A. 360).

While the question is not free from doubt, and there is much force in the defendant's contention that the well itself—the hole in the ground—does not wear out by use, as do tools, derricks, pumps, pipes, and other component parts of a completed producing oil well, we think the decisions of the Board of Tax Appeals in the cases cited are a correct interpretation of both the statute and the regulations. The drill hole of a producing oil well through which the oil is

brought to the surface of the ground is a necessary and inseparable portion of the physical property of a completed oil well. It, at least, bears as direct a relation to the casing, pumps, pipes, derricks, and other necessary equipment of the completed well as it does to the oil reserves under the ground. The hole in the ground it seems is as susceptible to depreciation by wear and tear through use as it is to "depletion" as that term is used in the revenue acts.

In United States v. Ludey (274 U. S. 295) the court said:

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any
16 year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed."

Article 201 of Regulations 69 provides that:

"DEPLETION OF MINES, OIL AND GAS WELLS; DEPRECIATION OF IMPROVEMENTS.—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions * * * but not including land values for purposes other than the extraction of minerals. * * *

"When used in these articles (201–237) covering depletion and depreciation—* * *

"(c) A 'mineral property' is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface only as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The value of a mineral deposit is the value of the mineral property, less the value of the plant and equipment, and less the value of the surface of the land for purposes other than mineral production. The cost of a

mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase."

While in essence the deduction for depletion does not differ from the deduction for depreciation (United States v. Ludey, supra), they are separate and distinct allowances, the depletion deduction applying to natural resources (oil in the case of an oil well), the depreciation deduction applying to improvements.

We think that the drill hole of a producing oil well is an improvement within the meaning of the statute, and that it is also physical property within the meaning of Articles 223 and 225 of the regulations. A producing oil well is undoubtedly a physical property. Only by the most refined process of reasoning can it be said that the derricks, casings, pumps, pipes, buildings, and other equipment constitute parts of such physical property and are improvements upon the costs of which depreciation deductions may be had, and that the drill hole in which the casing is placed and through which, by the use of the pumps and other equipment, the oil is brought from
17 beneath the ground to the surface is not a physical property or an improvement within the meaning of the statute and the regulations.

The physical property comprising a completed oil well includes every item of improvement or equipment necessary for the extraction of the oil from the ground. Without the drill hole the well is incomplete and would be a useless thing, in fact would not be an oil well. Can it reasonably be said, then, that this essential item of the component parts of the physical property comprising a completed producing oil well is not itself a physical property, or that it is not an improvement? We think not.

The expenses incurred by the plaintiff in drilling its wells, including wages, fuel, repairs, freight, hauling, and materials, have been capitalized. Under the statute and the regulations hereinbefore discussed these expenditures are returnable through depreciation.

The plaintiff is entitled to depreciation deductions claimed, and under the findings is awarded a judgment for $19,096.12, with interest thereon, as provided by law. It is so ordered.

WHALEY, Judge, and BOOTH, Chief Justice, concur.

Dissenting opinion

LITTLETON, Judge, dissenting:

I am of the opinion that plaintiff is entitled to recover only $8,420.21 resulting from an additional deduction for 1926 of $76,614.03 for depreciation of camp buildings, etc., well equipment, and materials, as set forth in finding 13. This deduction appears to have been disallowed by the commissioner for lack of proper segregation of certain costs. I think the development costs, totaling $18,907.74,

finding 15, which were early and preliminary costs incident to the leases and preliminary to drilling operations, paid out during 1922 to 1924, inclusive, for expenses and for interest and taxes, and charged on its books as depreciation on equipment, furniture, and fixtures; and the drilling costs, amounting to $71,321.21, which amount is exclusive of the costs of all casings and the placing of same, the costs of all tools, machinery, and equipment used in such drilling and the costs of erecting or installing such tools or equipment, are comprehended in the depletion allowance for exhaustion of the oil supply and may not, therefore, be included in the amount to be used in determining the reasonable allowances for depreciation. An oil well, that is, the hole in the ground, like real estate, is not naturally subject to depreciation through wear and tear. Its usefulness is exhausted as the oil is removed, but exhaustion is comprehended in the allowance for depletion. In the ordinary case the statute provides for a reasonable allowance for "the exhaustion, wear, and tear of property used in the trade or business," but in the case of oil wells the statute, section 234 (a) (8) of the revenue act of 1926, in providing for a deduction for depletion and for wear and tear, states that "In the case of * * * oil and gas wells * * * a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the commissioner with the approval of the Secretary." The costs which may be included in the amount to be used for the purpose of computing the allowance for depreciation must be
18 costs in relation to physical property which is subject to depreciation through wear and tear as distinguished from exhaustion. The deduction for depletion is a special application of the general rule allowing a deduction for exhaustion. The depreciation charge represents the reduction during the year of the capital assets through wear and tear of the plant used. The depletion is likened to the using up, i. e., exhaustion, of raw material in a manufacturing process. The terms "depletion" and "depreciation" are mutually exclusive: together they are the equivalent of the phrase "exhaustion, wear, and tear"; in the case of an oil well, however, the exhaustion is described as depletion. In view of the particular language of section 234 (a) (8) relating to oil and gas wells, I think exhaustion was intended to be included in the depletion allowance of 27½ per cent of the gross income from the property during the taxable year, and only compensation for wear and tear of physical property allowed in addition thereto. The regulations[1] prescribe this rule for the administration of the statute. They are expressly authorized and impliedly approved by Congress. They are reasonable and essential to the practical administration of the statute and are valid. (Brewster v. Gage, 280 U. S. 327, 335; Fawcus Machine Co. v. United States, 282 U. S. 375.)

[1] Reg. 45, art. 223; 62, art. 223; 65, art. 225; and 69, art. 223.

Dissenting opinion

GREEN, Judge, also dissenting:

I concur in the dissenting opinion of Judge Littleton. It seems to me that the expense of boring a hole in which a pipe is to be placed in event oil is discovered is of the same nature as expenses otherwise made to change the earth or the surface thereof which is being used in connection with an oil well. If the surface of the ground required considerable expense in leveling, no one would contend that the cost incurred should be included in determining depreciation. The expense in boring the hole was incurred in fitting the place where the hole was located to receive the apparatus used in operating an oil well, and the loss suffered when the hole becomes useless does not appear to me to be in the nature of depreciation as the word is used in the statute.

19 VI. *Judgment*

At a Court of Claims held in the city of Washington on the 5th day of July, A. D. 1932, judgment was ordered to be entered as follows:

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court decides that the plaintiff recover of and from the United States the sum of nineteen thousand ninety-six dollars and twelve cents ($19,096.12), with interest at the rate of six per cent per annum, from the dates of payments thereof to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of subsection (b), section 177 of the Judicial Code, being a part of the revenue act of May, 1928.

20 [Clerk's certificate to foregoing transcript omitted in printing.]

[Indorsement on cover:] File No. 37131. Court of Claims. Term No. 434. The United States, petitioner, vs. Dakota-Montana Oil Company. Petition for a writ of certiorari and exhibit thereto. Filed October 5, 1932. File No. 37131.

U. S. GOVERNMENT PRINTING OFFICE: 1932

17 Supreme Court of the United States

Order allowing certiorari

Filed November 14, 1932

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

148186—32

OCT 5 1932
CHARLES ELMORE CROPLEY

FILE COPY

No. 434

In the Supreme Court of the United States

OCTOBER TERM, 1932

THE UNITED STATES, PETITIONER

v.

DAKOTA-MONTANA OIL COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

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In the Supreme Court of the United States

OCTOBER TERM, 1932

No. 434

THE UNITED STATES, PETITIONER

v.

DAKOTA-MONTANA OIL COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the Court of Claims in the above case rendered July 5, 1932, and reported in 59 F. (2d) 853.

QUESTION PRESENTED

Whether under the Revenue Act of 1926 capital expenditures for preliminary development and also for the drilling of an oil well are to be recovered through an allowance for depreciation or for depletion.

STATUTES AND REGULATIONS INVOLVED

Section 204 (c) (2) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 16, provides:

> (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the prop-

> erty during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph. (U. S. C. App., Title 26, Sec. 935.)

Section 234(a)(8) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 42, provides in part:

> In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * * (U. S. C. App., Title 26, Sec. 986.)

Article 223 of Regulations 69, promulgated under the Revenue Act of 1926, provides:

> ART. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these

incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

STATEMENT

The findings of fact made by the Court of Claims (R. 5–9) may be summarized as follows:

The respondent, engaged in the production of oil during the years 1923 to 1926, spent sums on its properties in preliminary development, for camp buildings and equipment and in drilling. (R. 5.) These expenses were capitalized. (R. 6.)

The respondent duly filed its tax return for the calendar year 1926 and paid the tax reported on

this return. In this return respondent claimed a substantial deduction for depletion and $13,210.58 for depreciation on certain camp buildings and equipment. (R. 7.) Thereafter an amended return and claim for refund were duly filed, claiming increased deductions for depreciation in the total amount of $163,301.81 based upon depreciation on well equipment, drilling costs, camp buildings, lease equipment, and preliminary development. (R. 7.) The claim for an increased allowance for depreciation of camp buildings and equipment was allowed by the Commissioner of Internal Revenue and a refund tendered (R. 7) but the other claims for depreciation were denied (R. 7). The Court of Claims held that respondent was entitled to deduct depreciation for drilling costs and preliminary development and gave respondent judgment for $19,096.12. (R. 14.) Two judges dissented. (R. 14–16.)

The Government concedes that the respondent is entitled to a judgment of $8,420.21 because of the allowance of further depreciation upon the camp buildings and equipment. If the court below was correct in holding that the amounts expended for drilling costs are returnable through depreciation, the respondent is entitled to a further deduction for 1926 and a refund of $18,048.57. If, in addition, the early and preliminary costs incident to the leases and preliminary to the drilling, construction, and completion of the oil wells are returnable through depreciation, respondent is en-

titled to an additional refund of $1,047.55. If the respondent is entitled to recover all three items, the judgment should be for $19,096.12.

SPECIFICATION OF ERRORS

1. The Court of Claims erred in holding that capital expenditures for drilling an oil well are to be recovered through an allowance for depreciation rather than through an allowance for depletion.

2. The Court of Claims erred in holding that capital expenditures for preliminary development of an oil field are to be recovered through an allowance for depreciation rather than through an allowance for depletion.

3. The Court of Claims erred in giving judgment for the respondent for $19,096.12.

REASONS FOR GRANTING THE WRIT

1. In holding that drilling costs are returnable through depreciation instead of depletion the decision below is in direct conflict with a recent decision of the Circuit Court of Appeals for the Fourth Circuit. In *Burnet* v. *Petroleum Exploration*, decided October 3, 1932 (not yet reported but printed as an Appendix to this petition, *infra*, pp. 9–20), the Circuit Court of Appeals held that under the Revenue Act of 1926 capitalized drilling costs are not returnable by a depreciation allowance and that they can only be returned through allowance for depletion. The opinion expressly disapproves the decision of the majority of the Court of Claims in the instant case.

The Board of Tax Appeals, in *A. T. Jergins Trust* v. *Commissioner*, 22 B. T. A. 551,[1] and in other decisions following it, has ruled that drilling costs are recoverable through depreciation. Several of those decisions are now pending on appeal in different Circuit Courts of Appeals. While in the *Petroleum Exploration case*, *supra*, the Circuit Court of Appeals for the Fourth Circuit expressed its disapproval of the Board's decision in the *Jergins Trust case*, the Court of Claims in the instant case relied upon the *Jergins Trust* decision and followed it. While there is no direct conflict on the second issue as to the allowance of depreciation on preliminary development costs, which were not involved in the *Petroleum Exploration case*, we believe the allowance of depreciation on such costs was clearly wrong and should be reversed.

2. The question presented is one of current general importance. The statutory provisions involved are in force in almost identical form in the 1928 and 1932 Revenue Acts. (Section 114 (b) (3) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 821 (U. S. C., Sup. V, Title 26, Sec. 2114); Section 114 (b) (3) of the Revenue Act of 1932, Public No. 154, 72d Cong.) The question is presented in numerous cases now pending in the Bureau of Internal Revenue, the Board of Tax

[1] The Board's decision was reversed by the Circuit Court of Appeals for the Ninth Circuit on September 8, 1932 (not yet reported officially, see 1932 Prentice-Hall Federal Tax Service, Par. 1786), on grounds which made it unnecessary for the court to consider questions of depreciation or depletion.

Appeals, and the Circuit Courts of Appeals. The General Counsel of the Bureau of Internal Revenue states that it is present in cases before the Bureau involving claims for refund of approximately $5,000,000. The importance of the question from the taxpayer's point of view is that if expenses incurred in exploring and drilling oil and gas wells are subject to a depreciation allowance, the taxpayer will normally receive the full amount of the expenses through such allowance, whereas due to the statutory limitation on the amount allowable for depletion the full amount of such expenses would not be returned through depletion. Thus the instant decision approves the taxpayer's deduction of the capitalized cost of drilling, in addition to the statutory depletion allowance of 27½ per centum of income. It is reasonable to suppose, therefore, that in all cases involving capitalized expenses arising out of the exploration and drilling of oil and gas wells taxpayers will claim that expenses such as those involved in this case are subject to a depreciation rather than a depletion allowance. The interpretation of these statutory provisions is, therefore, of importance to both taxpayers and to the Government. The existing conflict will make it impossible to administer the statutes with any certainty or consistency until the conflict is resolved by a decision of this Court.

3. The statute permits a depletion allowance of 27½ per centum of the gross income from the prop-

erty. The majority of the Court of Claims in effect granted a much larger allowance by treating it as a deduction for depreciation. This was contrary to the regulations of the Treasury Department as construed by the officers charged with their administration. See Article 223 of Regulations 45, 1920 Edition; Article 223 of Regulations 62; Article 225 of Regulations 65; and Article 223 of Regulations 69. The court in the *Petroleum Exploration case* considered that these regulations controlled decision and held that they had received legislative approval. See *Brewster* v. *Gage*, 280 U. S. 327; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375.

CONCLUSION

Wherefore it is respectfully submitted that this petition should be granted.

THOMAS D. THACHER,
Solicitor General.

APPENDIX

UNITED STATES CIRCUIT COURT OF APPEALS, FOURTH CIRCUIT

No. 3316

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

versus

PETROLEUM EXPLORATION, RESPONDENT

ON PETITION TO REVIEW THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

(Decided October 3, 1932)

Before NORTHCOTT and SOPER, Circuit Judges, and GLENN, District Judge

NORTHCOTT, Circuit Judge:

This is a petition to review a decision of the United States Board of Tax Appeals reported in 23 B. T. A. 890.

The pertinent facts, about which there is no dispute, as found by the Board of Tax Appeals, are as follows:

> The petitioner (the taxpayer) is a corporation organized on September 25, 1916,

under the laws of the State of Maine, and its principal office is at Sistersville, W. Va.

* * * * *

The parties hereto have submitted the following stipulation of facts:

"1. On December 31, 1924, the undepreciated investment of Petroleum Exploration in equipment in oil wells amounted to $475,975.02.

"2. During the years 1925, 1926 and 1927 Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

Year	Cost of equipment	Cost of drilling wells, hauling and placing equipment	Total cost of completed producing wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

"3. The productive life of all producing wells, the total cost of which was capitalized as shown in paragraph No. 2, is more than one year.

"4. Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate, based on the length of life of the oil deposits.

"5. The Commissioner, in making his computation of depreciation, has added to his depreciation schedules the cost of the equipment added each year, as shown in paragraph No. 2, but has not added the cost

of drilling wells, hauling and placing the equipment.

"6. Instead, the cost of drilling wells, hauling and placing the equipment, as shown in paragraph No. 2, has been added to the cost depletion schedules by the Commissioner; but depletion has been allowed on a statutory percentage basis (27½ per cent. of gross income, not to exceed 50 per cent. of net income) and is not based on cost.

"7. The petitioner, in making its computation of depreciation as shown in its 'Form O', has added the total cost of completed wells, including equipment, drilling, hauling and placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

"8. If petitioner's method of computing depreciation be sustained by the Board, namely, by adding to the undepreciated investment shown in paragraph No. 1 the total cost of completed wells as shown in paragraph No. 2 (no part of such cost being added to the depletion schedules), an increase in the depreciation allowance will result as follows:

Depreciation allowance

Year	Computed by commissioner's method	Computed by petitioner's method	Increase in depreciation allowance if petitioner's method be sustained
1925	$82, 826. 35	$89, 369. 57	$6, 543. 22
1926	68, 105. 24	78, 192. 46	10, 087. 22
1927	66, 015. 91	75, 161. 03	9, 145. 12

"9. If petitioner's method of computing depreciation be sustained, as shown in para-

graph No. 8, a decrease in the depletion allowance will result as follows:

Depletion allowance

Year	Computed by commissioner's method	Computed by petitioner's method	Decrease in depletion allowance if petitioner's method be sustained
1925	$302,012.87	$300,860.43	$1,152.44
1926	277,900.70	275,191.94	2,708.76
1927	168,874.41	167,486.55	1,387.86

The Statutes and Treasury Regulations involved are:

Revenue Act of 1926, c. 27, 44 Stat. 9

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells, the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230, there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

Treasury Regulations 69

ART. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent. of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent. of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property, or its value at the basic date, as the case may be. In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

ART. 223. *Charges to capital and to expense in case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, build-

ing of pipe lines, and development of the property may, at the option of the taxpayer, be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells.

An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

ART. 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the tax-

> payer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit.

The sole question presented is whether the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through allowances for depreciation or depletion. The Commissioner of Internal Revenue determined that this cost was properly recoverable through an allowance for depletion. Upon hearing before the Board of Tax Appeals this determination of the Commissioner was reversed.

The Treasury regulations cited above are authorized by Congress, and while the Secretary of the Treasury cannot by a regulation alter or amend the law (*South Carolina Produce Ass'n.* v. *Commissioner*, 50 Fed. (2) 742), if within and in accordance with the acts of Congress such regulations have all the force and effect of statutes.

Burnet v. *Moore Cotton Mills Co.*, 49 Fed. (2) 59, and authorities there cited.

Brewster v. *Gage*, 280 U. S. 327.

Fawcus Machine Co. v. *United States*, 282 U. S. 375.

It has been repeatedly held by this court, and there is no authority to the contrary, that the action of the Commissioner of Internal Revenue in determining a tax assessment is *prima facie* correct, and the burden is on the objecting taxpayer to show the action of the Commissioner to be erroneous. *Lehman* v. *Tait,* 58 Fed. (2) 20, and authorities there cited.

Here the taxpayer was given the option under the provisions of Article 223 of Regulations 69 to either charge the expenditures in question to development expense or charge them to capital account *returnable through depletion.* (Italics ours.) This option was exercised by the taxpayer by charging the expenditures to capital account, and by so acting the taxpayer must have done so with the full knowledge that such sums so charged must come back through depletion and not depreciation. This is the plain provision of the Regulation.

It is true that Article 225 of Regulations 69 permits an allowance for depreciation of physical property, but only so far as not to conflict with the option exercised by the taxpayer as to charging such expenditures to capital account, and such allowance is given only for such physical property as "machinery, tools, equipment, pipes, etc." The hole of an oil well itself certainly would not come within this classification, and could not be held to be physical property.

We are here concerned with the cost of putting down the hole through which oil is recovered from under the ground. In the oil well the hole in the ground performs a function, with respect to the oil brought out of the well, similar to that performed by the shaft or tunnel in a mine with respect to the

ore brought out of the ground. Neither the shaft nor the hole can be, strictly speaking, termed improvements. They simply serve as conduits through which the mineral is recovered. The bare hole in an oil well does not deteriorate or depreciate as does a piece of machinery or as does the casing with which it is lined, and has no service life other than the period necessary to exhaust the body of the mineral which it reaches. Once the mineral is exhausted the hole is useless and of no value whatever, such as may be possessed by the casing which may be pulled or the machinery which may be removed to be used elsewhere. It seems to us that the proper and logical method of returning to the taxpayer the expense of drilling the hole is through depletion rather than depreciation, this entirely aside from the implied agreement to accept depletion when the taxpayer exercised the option to charge the expense to capital account.

The allowance for depletion was intended by Congress to restore to the taxpayer his capital investment with respect to the oil and gas wells as that investment is used up or exhautsed.

In *Lynch, Executrix,* v. *Alworth-Stephens Co.*, 267 U. S. 364, the Supreme Court said:

> It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce

> it to possession and ownership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other. * * *

If the cost of the hole is included in depreciation allowances as well as cost of machinery, tools, etc., which have a service life in no way connected with or dependent upon the length of time it takes to exhaust the mineral, then there is no expense whatever connected with an oil well left to be returned through depletion, and the regulation (Article 223) is robbed of any meaning, except as to the exploration of the property.

In *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, the Court said:

> It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost for March 1, 1913 value. It did not, however, attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue, who was to make rules and regulations to that end. Pursuant to this authority, regulations were made, which required the deduction of depletion theretofore sustained in ascertaining the capital remaining in any year recoverable by depletion deductions. * * *
>
> The decision in the Ludey case (*United States* v. *Ludey*, 274 U. S. 295) has been adopted in the later statutes as affecting sales of capital assets, but the provisions for an-

> nual depletion allowance has remained substantially unchanged. This in itself is persuasive evidence that Congress has approved the executive construction embodied in the regulations.

The long and consistent administrative construction, especially when it is, as here, clearly an admissible one and consistent with the purpose of the statute, should not be set aside unless plainly wrong. *Universal Battery Co.* v. *United States,* 281 U. S. 580; *Fawcus Machine Co.* v. *United States,* 282 U. S. 375; *Williams* v. *Burnet, Commissioner,* 59 Fed. (2) 357.

A consideration of this question leads to the conclusion that the elements calling for both depletion and depreciation are present in an oil well. The outlay for geological study and survey is directly connected with the location or discovery of the oil deposit, and would seem to be not subject in any way to depreciation, but should be allowed under depletion when capitalized. So with the hole in the ground. It can not be withdrawn or inventoried as having any independent value or resold as may be done with casing, tools or machinery. As the wages for labor and other expenses in connection with the transportation and work of a geologist in prospecting an oil field are a part of the cost of discovery or development so the wages for labor in drilling a well are such a part of the cost of discovery or development as are not susceptible of depreciation.

Section 204 of the Act of 1926, above set out, provides for "depletion and for depreciation of improvements," and goes on to leave the rules and regulations to be prescribed "by the commissioner with the approval of the secretary." Such rules and

regulations have been prescribed and are apparently reasonable and just. Under these regulations the cost of the drill hole of an oil well, and as it seems to us to be natural, is not subject to depreciation, but should be allowed for, especially when capitalized, under the head of depletion.

The Board of Tax Appeals rests its decision in the instant case on its decision in the case of *A. T. Jergens Trust Co.*, 22 B. T. A. 551, where a similar question was presented; and the Court of Claims in the recent case of *Dakota-Montana Oil Co.* v. *United States* (decided July 5, 1932), has by a majority opinion reached the same conclusion as the Board. We are, however, of the opinion that the regulations are reasonable and having been in force for a long time they should be sustained, particularly where the taxpayer, as in this case, availed itself of the identical regulations to capitalize expenditures for intangibles, thus accepting the provision that such expenditures should be returned through allowances for depletion. The taxpayer can not accept the benefits of the regulation and reject the accompanying obligation.

In conclusion we wish to say that if any of the expense of wages, hauling, etc., in connection with the casing, operating tools, machinery, etc., are included in the Commissioner's allowance for depletion it is our opinion that such expense should be depreciated. It is impossible for us to tell from the record the fact as to this question, but, as to allowances for all expense of putting down the drill hole the Commissioner was right in making such allowances under the head of depletion. It follows that the decision of the Board of Tax Appeals must be *reversed.*

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No. 434

In the Supreme Court of the United States

OCTOBER TERM, 1932

THE UNITED STATES, PETITIONER

v.

DAKOTA-MONTANA OIL COMPANY

ON A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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OPINION BELOW

The opinion of the Court of Claims is reported in 59 F. (2d) 853. (R. 5–16.)

JURISDICTION

The judgment of the Court of Claims was entered July 5, 1932. (R. 16.) Petition for a writ of certiorari was filed October 5, 1932 (R. 16), and granted November 14, 1932 (R. 17). The jurisdiction of this Court rests upon Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under the Revenue Act of 1926, capitalized expenditures for preliminary development

and the drilling of oil wells may be added to the cost of physical property subject to a depreciation allowance, or are returnable to the taxpayer through a depletion allowance.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are contained in Appendix A (*infra*, pp. 22–29).

STATEMENT

The respondent, engaged in the production of oil during the years 1923 to 1926, spent sums on its properties in preliminary development, in drilling oil wells, and for camp buildings and equipment. (R. 5, 8.) These expenses were capitalized. (R. 6.)

The respondent duly filed its tax return for the calendar year 1926 and paid the tax reported on this return. In this return respondent claimed a deduction of $159,200.71 for depletion and $13,210.58 for depreciation on certain camp buildings and equipment. (R. 7.) Thereafter an amended return and claim for refund were duly filed, claiming a deduction for depletion of $158,169.24, which was 27½ per cent of respondent's gross income from oil operations (R. 5), and an increased deduction for depreciation in the total amount of $163,301.81, based upon depreciation "on well equipment and on intangible drilling costs," "camp buildings and lease equipment," and "on preliminary development" (R. 7). The claim for an increased

allowance for depreciation of camp buildings and equipment was allowed by the Commissioner of Internal Revenue and a refund tendered, but the other claims for depreciation were denied. (R. 7.) The Court of Claims held that respondent was entitled to deduct depreciation for drilling costs and preliminary development and gave respondent judgment for $19,096.12. (R. 14.) Two judges dissented. (R. 14–16.)

It is conceded that the respondent is entitled to a judgment of $8,420.21 because of the allowance of further depreciation upon the camp buildings and equipment. This amount is not now in issue. If the court below was correct in holding that the amounts expended for drilling costs are returnable through depreciation, the respondent is entitled to a further deduction for 1926 and an additional refund of $9,628.36. If, in addition, the early and preliminary costs incident to the leases and preliminary to the drilling, construction, and completion of the oil wells are returnable through depreciation, respondent is entitled to an additional refund of $1,047.55.

SPECIFICATIONS OF ERROR

1. The Court of Claims erred in holding that capital expenditures for drilling an oil well are to be recovered through an allowance for depreciation rather than through an allowance for depletion.

2. The Court of Claims erred in holding that capital expenditures for preliminary development

of an oil field are to be recovered through an allowance for depreciation rather than through an allowance for depletion.

3. The Court of Claims erred in giving judgment for the respondent for $19,096.12.

SUMMARY OF ARGUMENT

I

Section 234 (a) (8) of the Revenue Act of 1926 provides for a reasonable allowance "for depletion and for depreciation of improvements" in the case of oil and gas wells, the allowance in all cases to be made under rules and regulations prescribed by the Commissioner of Internal Revenue. Pursuant to the authority so conferred, regulations were promulgated which distinguish between expenditures for physical property subject to depreciation and expenses incurred in exploration, drilling, and development which do not result in any tangible physical property. Expenditures of the latter class, if capitalized, are returnable only through a depletion allowance. The distinction made in the regulations between the two types of expenditures is based upon the nature of oil wells and the practices of the industry. Under the regulations, expenses for drilling wells are not regarded as resulting in physical property. The facilities provided by such expenditures have no useful life apart from the mineral reserve. It is logical that the return of such expenditures, if capitalized, should be through

depletion only. The regulations have a reasonable basis. Since the respondent exercised the option afforded by the regulations, it is bound thereby.

Not only were the regulations explicitly authorized by statute, but they have received implied legislative approval.

In view of the regulations, there is no basis for the argument that the depletion allowance under the statute is limited to an allowance for depletion of the oil reserve only, nor is there any basis for the argument that return of expenses for drilling through depletion allowance would not result in complete recovery of cost of drilling and cost of the oil reserve. Section 204 (c) provides explicitly that the arbitrary allowance of 27½ per cent shall not be less than the allowance would otherwise be, so that the taxpayer would be entitled to a larger depletion allowance if the arbitrary allowance were insufficient to return cost.

II

The preliminary expenses incident to the leases and preliminary to drilling, construction, and completion of oil wells are not subject to a depreciation allowance. So far as the record discloses their nature, they are clearly not expenses which represent property worn out with use, and in so far as their nature is not disclosed by the record there is nothing to indicate that the Commissioner's action in denying depreciation thereon was erroneous.

ARGUMENT

I

RESPONDENT'S EXPENDITURES FOR DRILLING OIL WELLS, HAVING BEEN CAPITALIZED, WERE RETURNABLE ONLY THROUGH A DEPLETION ALLOWANCE, AND THE RESPONDENT WAS NOT ENTITLED TO ADD THEM TO THE COST OF PHYSICAL PROPERTY SUBJECT TO DEPRECIATION

The court below sustained the respondent's claim that under Section 234 (a) (8) of the Revenue Act of 1926 it was entitled to add capitalized expenditures made for drilling oil wells to the cost of physical property subject to depreciation. Respondent's claim is for an allowance of depreciation upon such expenditures, in addition to the allowance of 27½ per cent of its gross income from oil-well operations for the taxable year which it has claimed and received as a depletion allowance. We contend that under the Revenue Act of 1926 and applicable valid regulations the respondent was entitled to have such capitalized expenditures returned only through the depletion allowance and that the decision of the court below allowing their return as depreciation was erroneous.

Section 234 (a) of the Revenue Act of 1926 (*infra*, p. 22) provides that in computing the net income of a corporate taxpayer certain deductions shall be allowed. The subdivision involved here is—

> (8) In the case of mines, oil and gas wells, other natural deposits, and timber, a rea-

> sonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

The basis for the allowance for depletion in connection with oil and gas wells is specified in Section 204 (c) (2) (*infra*, p. 22) as follows:

> In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Pursuant to the express authority conferred by Section 234 (a) (8), regulations were promulgated which provide in detail for the allowance of depletion and depreciation in connection with oil and gas wells. Regulations 69, Art. 223 (*infra*, p. 23), provides in part:

> Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a

> development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * * An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. * * *

Specific provision for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., is made in Regulations 69, Art. 225 (*infra*, p. 24). In 1932, Art. 223 of Regulations 69, its predecessors, and its successor under the Revenue Act of 1928, were restated by the Commissioner, with the approval of the Acting Secretary of the Treasury, to incorporate therein details of administrative application and practice of long standing without involving any change in administrative policy or practice. T. D. 4333 (*infra*, p. 25).

The articles of the regulations referred to above distinguish between expenditures for physical property subject to depreciation and expenses incurred in exploration, drilling, and development not resulting in any tangible physical property apart from the land. Expenditures of the latter class may, at the option of the taxpayer, be deducted as current expenses or be capitalized. If capitalized they are to be returned solely through a depletion allowance.

The basis for this distinction may be found in the peculiar nature of oil wells and the practices of the oil industry.[1] Analysis of the regulations in the light of the subject matter with which they deal shows that the distinction so made is clear and that it rests upon a reasonable basis. The type of "physical property" dealt with in Art. 223 is indicated by the specific reference to certain property in Art. 225. The property so mentioned is of a character which has an independent measurable service life depending on its own inherent qualities and the extent to which the property is subjected to use in connection with the enterprise. These factors determine the rate at which such property is consumed. The amount of annual depreciation of such property is readily ascertainable under familiar principles and by the usual methods for determining allowances for depreciation of property used up in the course of a business. Where expenses like those for wages, transportation, etc., are incurred in the process of providing such physical property so that they would normally be recognized as constituting a part of the cost of such property, they may be readily included in the cost and thus in the allowance for depreciation as the property is worn out.

[1] A study of the basis for the classification, prepared by Elden McFarland, Esq., Special Attorney in the Office of the General Counsel of the Bureau of Internal Revenue, in conjunction with the engineers of the Bureau, is printed as Appendix B (*infra*, pp. 36–37). It was printed as an appendix to the Government's brief in the court below.

On the other hand, expenditures in exploring for minerals (such, for example, as expenditures for surveying, geological work, etc.), for development (such, for example, as clearing the ground, draining, road making, grading, stripping, etc.), including the drilling of a hole for the casing so that oil may eventually be extracted, and the digging of shafts, tunnels, slopes, etc., in the case of a coal mine (see Art. 222, Reg. 69), do not result in any article of property apart from the land or susceptible of depreciation. They are identical in purpose and result with the operation of stripping the overburden from an open-pit iron-ore mine to make the mineral available for extraction; and it is obvious that "depreciation" can not be applied to the object of such an expenditure. The result of expenditures of this class is not to create a new item of property; its direct and its only result is to augment the value of the existing mineral reserve. While such expenditures may result in changes in the conformation of the land and are necessary to provide access to the oil supply in order to permit its eventual extraction, there is no gradual wearing out of such facilities. Since they have no further utility in the enterprise after all of the oil has been extracted, the conclusion of extraction and their consequent abandonment fixes the time when their usefulness ends. Thus, the facilities resulting from such expenditures are closely associated with and their useful life can be measured accu-

rately only by the mineral reserves. It would ordinarily be quite impossible to apply to them any of the usual methods of determining depreciation. By providing for return of these costs through depletion, if the taxpayer elects to capitalize them, the regulations realistically recognize that they should be considered as a part of the value of the mineral reserve, upon the exhaustion of which their usefulness depends. The logic of the regulations in treating such expenditures, if capitalized, as returnable only through depletion is recognized in *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273 (C. C. A. 4th), now pending on certiorari, *Petroleum Exploration* v. *Burnet*, No. 448, October Term, 1932.

The restatement of Art. 223 of Regulations 69 (*infra*, p. 25), which contains an exposition of the administrative application of this and similar articles under various regulations, clearly shows the distinction between expenses which are represented by tangible property and those which are not. Expenses for drilling wells are described as "intangible" drilling and development costs which the taxpayer may, at its option, charge to capital or expense. Such expenditures are considered as not represented by physical property. If the taxpayer, in the exercise of this option, capitalizes the cost of drilling, such expenditure is returned through the depletion allowance. The restatement further describes the expenditures which are represented by physical property, and are thus return-

able through depreciation under the applicable regulations. The distinction made by Art. 223 between capitalized expenses which are represented by physical property, and those which are not, has been consistently maintained in practice, and it is entirely clear that the administrative officers have considered that expenses for drilling oil wells, if capitalized, can, under the regulations, be returned only through a depletion allowance.

The respondent exercised the option provided by Art. 223 of Regulations 69 and elected to capitalize the expenses for drilling oil wells. Since under the regulations such expenses are not considered as represented by physical property, the effect of the exercise of the option was to provide for return of such expenses only through a depletion allowance. In *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273, *supra*, the court held under similar facts that if the option to capitalize such expenses was exercised by the taxpayer, returned thereof could only be obtained through a depletion allowance.

In view of the inherent nature of the product of such expenses, the anomaly which would result from treating them as depreciable (since the facilities which they create are not subject to be worn out through use), and the very clear practical reasons for treating them as returnable through depletion, we believe that the distinction made by the regulations is reasonable. The distinction thus plainly made in the regulations and consistently

recognized in their application is not to be destroyed by abstract definitions. The fact that the hole in the ground which is created when an oil well is drilled may be considered as having physical qualities does not affect the application of the regulations in this case. The expenditures for drilling the hole are not treated by the regulations as represented by physical property, and as there is a reasonable basis for this rule, which has been consistently recognized in practice, the regulations are not to be stretched to permit a deduction for depreciation in connection with such expenditures, which neither the letter nor the theory of the regulations authorizes.

The regulations were promulgated under express authority of Section 234 (a) of the Revenue Act of 1926. Allowances of deductions for both depletion and depreciation are to be made "in all cases" under rules and regulations prescribed by the Commissioner. The only restriction is that the allowances thus given be reasonable. *Murphy Oil Co.* v. *Burnet*, decided December 5, 1932, No. 80, October Term, 1932. Such regulations have the force and effect of law.

Not only are the regulations in question explicitly authorized by statute, but the distinctions contained therein have been consistently applied for many years, and the regulations have, therefore, the sanction of implied legislative approval. Since the Revenue Act of 1918, which in Section 234 (a)

(9) first provided separately for depreciation of improvements in the case of oil and gas wells in addition to the provision allowing deductions for "exhaustion, wear, and tear" generally, the distinction now contained in the regulations has been maintained.[2] The provisions in the several Revenue Acts since that of 1918 have included depletion and depreciation of improvements in the case of oil and gas wells in the same paragraph and have consistently authorized allowance under rules and regulations promulgated by the Commissioner.[3] Although Section 204 (e) of the Revenue Act of 1926, providing that the allowance for depletion should be an arbitrary percentage of gross income from the property during the taxable year, except where such allowance was less than it would otherwise be, thus fixing its minimum but not its maximum, changed the method of computing the allowance provided by the earlier Acts, this change did not affect the provisions of Section 234 (a) (8) and its predecessors so as to require a departure from

[2] Arts. 223 and 225, Regulations 45, under the 1918 Act; Arts. 223 and 225, Regulations 62, under the 1921 Act; Arts. 225 and 227, Regulations 65, under the 1924 Act; Arts. 223 and 225, Regulations 69 (*infra*, p. 23), under the 1926 Act; Arts. 243 and 245, Regulations 74, under the 1928 Act; T. D. 4333, Internal Revenue Bulletin, Vol. XI, No. 15 (*infra*, p. 25), promulgated before the enactment of the 1932 Act.

[3] Section 234 (a) (9), Revenue Act of 1921; Section 234 (a) (8), Revenue Act of 1924; Section 234 (a) (8), Revenue Act of 1926 (*infra*, p. 22); Section 23 (l), Revenue Act of 1928; Section 23 (l), Revenue Act of 1932.

the distinction between property subject to depletion and that subject to depreciation, consistently maintained in the regulations. Section 234 (a) (8) of the Revenue Act of 1926 was reenacted as Section 23 (l) of the Revenue Acts of 1928 and 1932. Articles 243 and 245 of Regulations 74, under the Revenue Act of 1928, are in the same form as Articles 223 and 225 of Regulations 69 under the 1926 Act, and the restatement in T. D. 4333 of these articles under the various regulations which expounded the administrative practice thereunder was promulgated before the enactment of the Revenue Act of 1932.

Thus the authority of the Commissioner to regulate the allowance of depletion and depreciation in the case of oil and gas wells was not only expressly granted by Congress, but its exercise in the regulations here involved has the additional sanction of implied legislative approval. See *Murphy Oil Co.* v. *Burnet, supra*; *Interstate Commerce Commission* v. *New York, New Haven & Hartford R. Co.*, decided November 21, 1932 (No. 15, Oct. Term, 1932); *McCaughn* v. *Hershey Chocolate Co.*, 283 U. S. 488, 492; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378; *Brewster* v. *Gage*, 280 U. S. 327, 336. In *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, this Court referred to the delegation by Congress to the Commissioner of the function of making rules and regulations provid-

ing for the allowance of depletion in connection with oil wells, and said (pp. 307–308):

> The decision in the *Ludey* case [*United States* v. *Ludey*, 274 U. S. 295] has been adopted in later statutes as affecting sales of capital assets, but the provision for annual depletion allowance has remained substantially unchanged. This in itself is persuasive evidence that Congress has approved the executive construction embodied in the regulations.

In *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273, *supra*, where the precise question now involved was considered, the court held that under the regulations the cost of drilling an oil well was not subject to depreciation, but was, if capitalized, subject to a depletion allowance, and sustained the regulations.[4]

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[4] The first ruling that capitalized development expenditures of the kind now involved are depreciable was that of the Board of Tax Appeals in *A. T. Jergins Trust*, 22 B. T. A. 551 (March, 1931). The decision in that case was reversed by the Circuit Court of Appeals without consideration of the present question (__ F. (2d) __), and is now pending in this Court on petition for certiorari, No. 541, October Term, 1932. The Board of Tax Appeals in the *Jergins case* did not hold the applicable regulations invalid, but the decision appears to have been based primarily upon the terms of the stipulation in the case. The Board followed its decision in the *Jergins case*, without considering the question again, in *Petroleum Exploration*, 23 B. T. A. 890, reversed 61 F. (2d) 273 (C. C. A. 4th), *supra*; *Albert W. Ziegler*, 23 B. T. A. 1091; *P-M-K Petroleum Co.*, 24 B. T. A. 360; *United Oil Co.*, 25 B. T. A. 101. In *Freeman-Hampton Oil*

In its brief in opposition in the instant case the respondent contended that if the regulations did not permit it to recover intangible drilling costs through a depreciation allowance they were in conflict with the statute and hence invalid. The basis for this contention was the argument that the statute provided for depletion only in connection with the oil reserves, while all expenses in connection with the exploration and development of the property were, under the statute, returnable through depreciation. When it is considered that development costs only add to the value of the reserves, and when the theory of depletion is compared with that of depreciation, it is clear that the statute may not be so construed. While Congress undoubtedly might have limited the depletion allowance to the value of the oil reserves only, exclusive of development costs, it seems clear that the allowance for depletion is not so limited. Indeed, the terms of Section 234 (a) (8) furnish a further indication that Congress did not intend to limit the recovery through depletion to the oil reserves, for the statute refers to *mines* and oil and gas *wells*, and not to coal or iron or oil *deposits*.

The respondent also suggested in its brief in opposition that failure to allow depreciation upon the

Corp., 24 B. T. A. 319, the Board indicated that, were it not for the terms of the stipulation in that case, it might be necessary to reconsider its previous decision in the *Jergins case*.

cost of drilling oil wells would result in hardship, since the taxpayer would not recover the full cost of drilling through a depletion allowance. There seems to be no foundation for this suggestion. While Section 204 (c) (2) provides that "the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year," it also provides "that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." The court below found that the productive life of all producing oil wells in connection with which the capitalized expenditures were made was more than one year. Under the express provisions of Section 204 (c) (2) the taxpayer was entitled to a larger allowance for depletion than the arbitrary allowance of 27½ per centum if the arbitrary allowance was less than it would be under Sections 204 (c) and 234 (a) (8) without regard to Section 204 (c) (2). There is nothing in the findings to indicate that the allowance of 27½ per centum would not eventually restore the full cost or value of the oil reserve, including development and drilling costs. It seems clear under the statute that, if the arbitrary allowance were not sufficient to return such cost and the other capitalized expenditures subject to a depletion allowance under the regulations, a larger allowance for depletion was authorized. See Art. 221, Regulations 69. On the other hand, if the arbitrary allowance exceeded the depletion allowable on the basis contended for by respondent, and it were also

allowed depreciation on development costs, the respondent's investment would be twice returned to it to the extent of the excess of depletion allowed over depletion sustained.

II

THE EXPENDITURES PRELIMINARY TO DRILLING WERE RETURNABLE THROUGH DEPLETION

In addition to the expenses of drilling, the respondent claims the right to deduct depreciation on certain expenses described as "early and preliminary costs incident to the leases and preliminary to the drilling, construction, and completion of oil wells." (R. 8.) The Commissioner required the respondent to capitalize such expenditures and treated them as not subject to a depreciation allowance. The court below held, however, that they, like the drilling costs, were subject to depreciation. The expenditures as itemized in the findings of the court below consists of "expenses, depreciation on equipment, depreciation on furniture and fixtures, royalties, interest and taxes." There is nothing in the findings to indicate that any of these expenditures were represented by physical property. Accordingly, under the terms of the regulations they were, if capitalized and if made in connection with the exploration and development of oil wells, subject only to a depletion allowance. Preliminary expenses of this kind were not in-

volved in *Petroleum Exploration,* 23 B. T. A. 890, *supra,* or in *A. T. Jergins Trust* v. *Commissioner,* 22 B. T. A. 551, *supra.* Cf. *Freeman-Hampton Oil Corp.,* 24 B. T. A. 319, *supra.*

Depreciation of equipment, furniture, and fixtures clearly could not be the basis for additional depreciation. See Regulations 69, Art. 203 (a).

The circumstances under which royalties were paid do not appear in the findings. If they were returnable at all, the return could only be through depletion; depreciation can not be applied to them. See Regulations 69, Art. 216. Cf. *Murphy Oil Co.* v. *Commissioner,* decided December 5, 1932, No. 80, Oct. Term, 1932; *Burnet* v. *Harmel,* decided November 7, 1932, No. 26, Oct. Term, 1932. Whether the respondent was entitled to a depletion allowance thereon need not be determined in the instant case, since it does not appear that the allowance of 27½ per cent was inadequate and the respondent does not assert a right to obtain any further depletion allowance.

The nature of the payments for expenses, interest, and taxes does not appear, and in the absence of any showing that the Commissioner's action was erroneous it should have been sustained by the court below. As our discussion of the regulations under Point I establishes their validity, we believe that, if applicable at all to the items now involved, the regulations plainly deny any allowance upon such items for depreciation, and further discussion thereof seems unnecessary.

CONCLUSION

The judgment of the Court of Claims should be reversed, with directions to enter a judgment for the respondent in the sum of $8,420.21.

Respectfully submitted.

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JANUARY, 1933.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 41:

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph. (U. S. C. App., Title 26, Sec. 935.)

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depre-

ciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; (U. S. C. App., Title 26, Sec. 986.)

Treasury Regulations 69:

ART. 221. DEPLETION IN THE CASE OF OIL AND GAS WELLS.—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

ART. 223. CHARGES TO CAPITAL AND TO EXPENSE IN THE CASE OF OIL AND GAS WELLS.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so

far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompanying the return.

ART. 225. DEPRECIATION OF IMPROVEMENTS IN THE CASE OF OIL AND GAS WELLS.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satis-

faction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)

Treasury Decision 4333, Internal Revenue Bulletin, XI, April 11, 1932, No. 15, pp. 2–3:

SECTION 23 (m).—DEDUCTIONS FROM GROSS INCOME:

BASIS FOR DEPRECIATION AND DEPLETION

Article 243: Charges to capital and to expense in the case of oil and gas wells. XI–15–5440 T. D. 4333

INCOME TAX

Charges to capital and to expense in the case of oil add gas wells—Restatement of article 223, Regulations 45; article 223, Regulations 45 (1920 edition); article 223, Regulations 62; article 225, Regulations 65; article 223, Regulations 69; and article 243, Regulations 74.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 223 of Regulations 45, article 223 of Regulations 45 (1920 edition), article 223 of Regulations 62, article 225 of Regulations 65, article 223 of Regulations 69, and article 243 of Regulations 74 are hereby restated so

as to incorporate therein certain details of administrative application and practice of long standing. No change in administrative policy or in the practice under the regulations is made, or intended to be made, by this restatement; nor is any new option or election as to the treatment of the expenditures involved granted or intended to be granted. The new matter appearing in the restatement represents the practice of the Bureau of Internal Revenue under the regulations since prior to the promulgation of Regulations 45, on April 16, 1919. That portion of article 223, Regulations 45; article 223, Regulations 45 (1920 edition); article 223, Regulations 62; and article 225, Regulations 65, dealing with casing-head gas contracts and the use of inventories, is not restated. The restatement follows:

Charges to capital and to expense in the case of oil and gas wells.—(a) Items chargeable to capital or to expense at taxpayer's option. (1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road-making, surveying, and geological work as are neces-

sary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and development items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells may at the option of the taxpayer be deducted from gross income as an expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) Elections once made under these options will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(*b*) Recovery of optional items, if capitalized. (1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. Such expenditures are, amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract such costs shall be subject to the foregoing segregation for the purposes of determining the depletion and depreciation allowances.

(*c*) Nonoptional items distinguished. (1) Capital items: The option with respect to intangible drilling and development costs in general does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a sal-

vage value. Examples of such items are the costs of the *actual materials* in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the options provided by this article, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items, even when incurred during the development of the property.

DAVID BURNET,
Commissioner of Internal Revenue.

Approved March 30, 1932.

A. A. BALLANTINE,
Acting Secretary of the Treasury.

APPENDIX B

STUDY OF BASIS OF CLASSIFICATION WITH RESPECT TO DEPLETION AND DEPRECIATION OF CAPITAL EXPENDITURES IN CONNECTION WITH OIL WELLS

(Prepared in Bureau of Internal Revenue)

The exploitation of an oil lease, from the standpoint of the producer as distinguished from the carrier, refiner, or marketer, may be divided into three general stages: (1) Exploration and preliminary development; (2) drilling and equipping wells; (3) operation.

The first may or may not be the source of major expenditures. If the operator merely makes a location on land in a settled community near an existing road and water supply, by guess instead of geological study or survey, he has practically no preliminary development costs. On the other hand, it is often necessary to make extensive geological, geophysical, and topographic surveys, construct roads, clear and drain land, provide water supplies, and construct extensive camps before actual drilling of wells begins.

In the drilling of a well heavy machinery must be transported to the site, a boiler and engine must be set up, and a derrick of wood or steel must be erected for handling the tools and casing. This must be equipped with drilling machinery. There is also a certain amount of surface excavation and other similar work before drilling begins. Where high pressures are expected it is modern practice to

construct an elaborate concrete "cellar" through which the drilling is carried on. Large supplies of fuel must be provided, and the transportation of the fuel, other supplies, casings, and equipment may be one of the important items of expenditure. Both skilled and unskilled labor are required for the actual drilling operation. The labor is expended partly in making the hole and partly in the installation of the casing and other equipment. When the hole has reached a depth of a few hundred feet at large diameter it is lined with steel casing, which is usually cemented into place at the bottom. Drilling then proceeds through this casing several hundred feet deeper, when a second casing of smaller diameter is placed inside the first, reaching from the surface to the bottom of the hole, and drilling then goes on. Often a well has several concentric casings of which only the innermost and smallest reaches to the ultimate depth.

If the well is unsuccessful there is a further use of labor, fuel, hauling, etc., in salvaging the equipment and a part of the casing. If the well is successful, a producer, there is a further use of labor in making it ready to flow or to be pumped, including the construction of flow lines and flow tanks. The construction of main pipe lines, large storage tanks, and refining and converting apparatus is not generally considered to be a part of the development work. All subsequent work on the property in connection with pumping or maintenance of wells after completion is considered to be operation and is invariably charged to expense.

In considering the foregoing from the standpoint of the present problem (Depletion and Depreciation), one becomes impressed with the thought that

both elements are present in an oil well. Thus, the outlay for geological study and survey would seem to attach directly to the location or discovery of the oil deposit itself, as distinguished from the removal of such deposit, and, therefore, seems closely allied to such deposit. There is nothing depreciable in the nature of such a cost. On the other hand, machinery, tools, equipment, pipes, etc., unquestionably partake of the nature of the depreciable items.

Where should the line be drawn?

The consideration of a practical case is pertinent.

"A" acquires an oil lease. He drills a producing well at a total cost of $100,000.00; $40,000.00 thereof is the cost of equipment, such as derrick, casing, machinery. This includes not only the original purchase price but expenses of hauling and of installation, including wages of workmen, fuel, etc.; $60,000.00 thereof is the cost of the drilling and its natural incidentals, such as hauling of drilling equipment, wages, fuel. In his property account "A" shows $40,000.00 in the various physical assets and properly subjects them to depreciation. But the $60,000.00 for the drilling of the well is of a different character. It is represented by a hole in the ground. The hole does not wear out by use, as do the tools or engines. It is not consumed by the elements as is a derrick or a house. It is not used up in the production of income. It does not diminish in value due to the passage of time as does the lease. It can not be withdrawn, inventoried, or resold, as may be done with casings. Its value lies only in relation to the mineral deposit which has been discovered, developed, and made available by it. The well is a development of the oil itself—a

part of the developed deposit. So "A" charges the $60,000.00 to "cost of oil deposit."

If "A" then sells the well to "B" for $150,000.00, "B" inventories his equipment at $40,000.00 (its cost to "A" and its actual value). How shall he record the remaining $110,000.00? We know the $60,000.00 was expended for drilling and expenses incidental thereto. It is a development of the oil deposit. So "B" charges the $110,000.00 to cost of oil deposit.

Thus there has developed a terminology peculiar to oil and gas wells—the use of the expressions tangible and intangible costs. It became necessary to designate such expenditures as related to physical assets which readily admit of depreciation and those relating to assets which do not readily lend themselves to such classification. Thus the costs, lumber, cement, casing, tubing, machinery, tools, and derricks are characterized as *tangible* costs, while geological costs, surveying, hauling, wages, and fuel were characterized as *intangible* costs.

These intangible costs were of two kinds: (1) Those relating to physical assets, and (2) those not relating to physical assets. Thus wages, fuel, and hauling in connection with the erecting of a derrick, of the placing of the casing, or the installation of machinery were of the first class and if capitalized were depreciable. But expenditures for geological surveys, hauling of surveying instruments, expenses of surveying, hauling of drilling tools, wages, fuel, and hauling connected with exploration, drilling and development connected with geological work, being of a class directly related to exploration, development, and discovery of the mineral it-

self, were more closely allied to the natural deposit than to a so-called "physical asset." Such expenditures, although incidental to the drilling of a well, often assume major proportions.

It is such expenditures with which we are concerned in the instant case—incidental expenditures for wages, fuel, hauling, etc., in connection with the exploration, drilling, and development of * * * leases, * * * not *represented by physical properties.*

The instant case is *not* concerned with wages, fuel, or hauling expenses in connection with *physical* properties, i. e., casing, derrick, machinery, etc. These costs, if capitalized, are unquestionably of a depreciable nature and have always been so regarded in administering the statute.

This case *is* concerned with expenditures for wages, fuel, and hauling expenses in connection with exploration, drilling, and development, but *not* represented by physical properties.

When the Revenue Act of 1918 was passed, Section 234 (a) (9) provided for a reasonable allowance for depletion of oil and gas *wells* and depreciation of improvements of oil and gas *wells,* "based on cost, including cost of development not otherwise deducted." The section also provided that such reasonable allowance was to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary.

The making of such regulations required the solution of several problems of statutory construction and of practical administration.

The statute permits a reasonable allowance for depletion and depreciation of improvements of oil

and gas wells, based on cost, including cost of development.

What does the statute mean when it says depletion of oil and gas *wells?* Does it mean depletion of the *well* as it actually says? Or does it mean depletion of the "mineral deposit" alone? Does "well" include "mineral deposit" or does it mean "mineral deposit" without the "well"? What does the statute mean by "depreciation of improvements"? What are the "improvements"? And when the statute says "based on cost including cost of development," does it mean that "improvements" are the same as "development," and is "cost of development" part of the basis for depletion?

And where the statute provides that *depletion* based on discovery value "shall be based upon the fair market value of the property * * *," what is the *property* upon the value of which *depletion* is to be based? Is it the *mineral deposit exclusive of the well?* Is it the *mineral deposit and well,* and *improvements* and machinery, or is it the deposit, the hole in the ground, and so much of the surface as is necessary to drill and operate?

And if the value of the well, i. e., the drill hole, is part of the basis of depletion in case of discovery, should it or should it not be part of the basis for depletion where discovery is not an element?

These and many other uncertainties are covered by the regulations in various articles, beginning with Article 201 through Article 226 of Regulations 45.

In Article 220 (a) (3) we find the following:

> The "property" which may be valued after discovery is the "well." For the purposes

> of these sections the *"well"* is the *drill hole*, the *surface* necessary for drilling and operation of the well, the *oil or gas content* of the particular sand zone or reservoir * * * in which discovery was made by drilling * * *. (Italics ours.)

Obviously the drill hole is an inseparable part of the *discovery and development* of the oil deposit. The foregoing regulation is in direct harmony with the letter as well as the intention of the statute, which provides for *depletion* of a *well*.

And if the value of the drill hole is a proper subject for depletion in case of discovery, there seems no logical reason for a distinction in the case of depletion *not* based on discovery. The cost thereof is as much an inseparable part of discovery and development of the mineral deposit itself in one case as in the other.

So, in Article 223, Regulations 45, it is provided that the cost of productive wells and nonproductive wells, costs of drilling, having been capitalized, are returnable through depletion and depreciation. Those expenditures for wages, fuel, repairs, hauling, etc., in connection with *drilling* and *development*, having been capitalized, are returnable through *depletion unless* represented by or made in connection with physical properties, in which latter case they were returnable through depreciation.

Improvements were defined in Article 225, Regulations 45, as relating to equipment, machinery, tools, pipes, etc., and this article specifically deals with depreciation of improvements.

Thus was the distinction clearly drawn between the *well* (including the drill hole, mineral deposit, and necessary surface) as being subject to deple-

tion and *physical* properties (as distinguished from development and discovery of the mineral deposit) as being subject to depreciation.

Expenditures for wages, fuel, hauling, etc., relating to a capital asset quite obviously partake of the nature of that asset and become a part of its cost.

Thus the labor on a building is just as much a part of the cost thereof as the lumber used in its construction. And the wages for labor in transporting a geologist to a prospective oil field are just as much a cost of discovery or development as the retainer of the geologist. And wages for labor in drilling a well, in so far as they relate to the drill hole, partake of the nature of the drill hole, and in so far as they relate to the placing of the casing, they form part of the cost of the casing in place.

So the provision in the regulation giving the capitalized expenditures the nature of the asset upon which they are expended is logical.

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Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 434.

THE UNITED STATES, PETITIONER,
v.
DAKOTA-MONTANA OIL COMPANY.

On Petition for Writ of Certiorari to the Court of Claims.

BRIEF ON BEHALF OF RESPONDENT IN OPPOSITION.

HERMAN J. GALLOWAY,
LOUIS P. DONOVAN,
Attorneys for Respondent.

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Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 434.

THE UNITED STATES, *Petitioner*,
v.
DAKOTA-MONTANA OIL COMPANY.

On Petition for Writ of Certiorari to the Court of Claims.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

OPINION BELOW.

The findings of fact and the opinion by the Court of Claims are reported in 59 Fed. (2d) 853.

JURISDICTION.

The judgment of the Court of Claims was rendered on July 5, 1932 (R. 16). Petition for writ of certiorari was filed on October 5, 1932 (R. 16). Jurisdiction is invoked under the authority of Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether under the Revenue Act of 1926 an allowance for depreciation should be made upon the costs of drilling an oil well, the wells upon which the expenditures were so made resulting in producing wells, the production of oil from such

wells being included in the income for the taxable year and the expenditures for the drilling cost having been capitalized?

STATUTES AND REGULATIONS INVOLVED.

The pertinent portions of the Revenue Act of 1926 (Ch. 27, 44 Stat. 9, 16, 26, 41) are as follows:

"SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that — * * *

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

"SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * * * * * * * *

"(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *"

"(9) In the case of * * * oil and gas wells, * * * a reasonable allowance for * * * depreciation of improvements, according to the peculiar conditions in each case; * * *."

"SEC. 234 (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." * * *

The following articles of Regulations 69, promulgated under the Revenue Act of 1926, are pertinent:

"DEDUCTIONS ALLOWED CORPORATIONS:

"ART. 561. *Allowable deductions.*—In general the deductions from gross income allowed corporations are the same as allowed individuals, * * *. Particularly, * * * as to depreciation, see articles 161–170; as to depletion, see articles 201–237; * * *."

"ART. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years."

"ART 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such

property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)"

STATEMENT.

The findings of fact made by the Court of Claims (R. 5 to 9) may be summarized as follows:

The respondent, a North Dakota corporation, kept its books and made its income tax return for the calendar year 1926 on an accrual basis (R. 5). During the years 1923 to 1926, both inclusive, respondent expended a large sum of money for labor, fuel, hauling, freight, supplies, material and equipment used in drilling oil wells, casing the same, erecting derricks, etc., and for all items of cost in the drilling and completion of producing oil wells ready to connect the same to a pipe line (R. 5). The findings of fact show the amounts spent each year for the following separate divisions of expense: (1) Cost of equipment and materials; (2) Cost of freight, hauling, installing equipment and materials, and (3) Total cost of drilling (labor, fuel, etc.) (R. 5). All of these expenditures were capitalized by respondent and included in its invested capital. The productive life of all of these producing wells, the expenditures for which were so capitalized, was more than one year (R. 6). The findings of fact also show the estimated oil reserves on the properties upon which these expenditures were made during the pertinent years, and show the amount of oil produced from such properties during the calendar year 1926 (R. 6).

The respondent claimed a deduction for depletion of 27½ per cent of its gross income from these properties during the taxable year in accordance with the provisions of the statute, and also claimed a depreciation upon a unit of production based upon the total amount expended in the drilling and completion of such producing oil wells (R. 7). The Commissioner of

Internal Revenue then allowed the deduction for depletion as claimed, but allowed a deduction for depreciation only upon the costs of the equipment and materials and rejected the claim for a depreciation upon the cost of (1) freight, hauling, installing equipment and materials, and (2) the total cost of drilling (R. 7).

The respondent then brought this action in the Court of Claims to recover the tax imposed and collected by the Government because of the disallowance of the depreciation claimed, and the Government stipulated that the allowance for depreciation should be increased, and among other things conceded that an allowance for depreciation should be made not only upon the cost of equipment and materials which the Government had previously allowed but also that an allowance for depreciation should be made upon the cost of freight, hauling and installing of the equipment and materials (R. 10), which concessions resulted in an admitted overpayment of tax by respondent in the sum of $8,420.21 (R. 9). The Government, however, contended that the actual cost of drilling the well, including the labor, fuel, etc., that is the cost of putting the drill hole in the ground, should not be made the subject of depreciation, but was covered by the allowance for depletion (R. 10). The Court of Claims determined that not only (1) the costs of the equipment and materials and (2) the cost of the hauling, freight, etc., of the equipment and materials should be subjected to an allowance for depreciation, but that the entire cost of creating the producing oil well including (3) the drilling costs should be made the subject of an allowance for depreciation (R. 9 to 14) and rendered its judgment accordingly.

During the calendar years 1922, 1923, and 1924, the respondent had charged as operating costs certain expenditures made by it for early and preliminary costs incident to the oil leases and preliminary to the drilling, construction, and completion of the oil wells (R. 8). The Government required the respondent to set up said expenditures in its tax returns for the calendar year 1926 as capital investments, and accordingly increased respondent's capital investment for that calendar year in the amount so set up (R. 8). The respondent claimed a deduction for depreciation upon these expenditures and the

Court of Claims allowed such depreciation. The Court of Claims rendered judgment for the respondent for the principal sum of $19,096.12 (R. 16), which included the sum of $8,420.21 conceded by the Government.

ARGUMENT.

There is little attempt beyond the formal "Specification of Errors" in the Government's brief at p. 5, to show that the decision of the Court of Claims is wrong. The argument is based in the main upon the contention that the question involved is an important one in the administration of the tax laws, that there are other cases involving a large sum of money which will depend upon the decision of this question, and that the decision of the Court of Claims is in conflict with the decision by the United States Circuit Court of Appeals for the Fourth Circuit in the case of *Burnet, Commissioner,* v. *Petroleum Exploration,* decided on October 3, 1932 (not yet reported but printed as an appendix to the petition for writ of certiorari). The respondent contends that the decision by the Court of Claims is preeminently sound, and that the decision by the Circuit Court of Appeals for the Fourth Circuit is unsound. The respondent therefore respectfully submits to the court that if it establishes in this brief in opposition to certiorari that the decision by the Court of Claims is sound this court should deny the petition for writ of certiorari regardless of the importance of the question or the number of other cases that may turn upon its decision. To do otherwise would impose an unfair hardship and burden upon the respondent. The respondent has been deprived by the Government of its money under the guise of taxation. It has been diligent in the assertion of its rights. It has prevailed in a trial of its case in a court of justice and has procured the rendition of an opinion which is sound and correct. To require the respondent in these circumstances to bear the burden of further trying this case simply because of the importance of the question presented, even though the decision by the lower court may be right, results in irreparable injury, damage and hardship to the respondent, especially in view of the fact that there is no means

of having additional costs or damages assessed against the United States.

It is therefore respectfully submitted that if the respondent establishes to the satisfaction of this court that the decision by the Court of Claims is sound and correct, the petition for writ of certiorari in this case should be denied regardless of the importance of the question or the amount involved in other cases.

Both the Statute and the Treasury Regulations Require the Allowance of a Depreciation upon Drilling Costs.

Section 234 (a) (8) of the Revenue Act of 1926 provides:

"(a) In computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as deductions:

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *"

This statute expressly requires that depletion shall be allowed. It also expressly requires that an allowance shall be made for depreciation of improvements. Depletion and depreciation are separate and distinct. Each has a well defined meaning. The word "depletion" is derived from the Latin word "deplere," meaning to empty or exhaust. "Depreciation" is derived from the Latin word "depretaire," meaning to lessen in price or value. The word "improvement" also has a well known meaning, and is defined as being that by which the value of anything is increased or as an amelioration of the condition of property affected by the expenditure of labor or money for the purpose of rendering it useful for other purposes than those for which it was originally used, or more useful for the same purpose.

Applying these definitions to the statute, it means that there shall be in the case of oil wells or other natural deposits a reasonable allowance for the emptying or exhaustion of the

deposits, and a reasonable allowance for the lessening in value or the increased value of the property resulting from the expenditure of labor or money. The decision by this court in the case of *United States* v. *Ludey*, 274 U. S. 295, clearly shows that such definition and meaning was that which Congress had in mind in the Revenue Acts relating to oil wells. At p. 300 the court said:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. * * *"

Again, on p. 302, the court said:

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion."

The court, in that same case, at p. 303, pointed out that the Corporation Tax Law of 1909 contained no provision for deductions on account of the depletion of mineral reserves, and said:

"The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 and all later Acts for some deduction on acount of depletion in determining the amount of the taxable income from mines. It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties. The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks. It is argued that, because oil is a fugacious mineral, it can not be known that the reserve has been diminished by the operation of wells. Perhaps some land may be discovered which, like the Widow's cruse, will afford an inexhaustible supply of oil. But the common experience of man has been that oil wells, and the territory in which they are sunk, become exhausted in time. Congress in providing for the deduction for depletion of oil wells acted on that experience. Compare *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. In essence, the deduction for depletion does not differ from the deduction for depreciation."

It is respectfully submitted that Congress specifically provided in Section 234 of the Revenue Act of 1926, that there should be an allowance for depletion or exhaustion of the natural deposits, that is, an allowance for the diminution of that which had been placed upon the property by Nature. Congress further provided that there must be a reasonable allowance for the depreciation of improvements, that is, an allowance for the diminution in value of that which had been placed upon the property by man.

It is further submitted that a proper construction of the regulations issued by the Treasury Department is not at all in conflict with this expressed purpose and intent of Congress, but is in full accord with the same.

Article 221 of the Regulations provides that the taxpayer may deduct on account of depletion an amount equal to 27½

per cent of the gross income from the property during the taxable year. This is merely the adoption of the method specifically provided in the statute. It will be recalled that prior to the Revenue Act of 1926 depletion was calculated upon a unit of production basis, and upon a discovery value. The flat percentage was adopted by Congress to avoid the difficulties and uncertainties of the calculation of the discovery value.

Article 223 of the Regulations undertakes to give to the taxpayer the option of charging drilling costs to operating expenses or to invested capital, and provides that if charged as operating costs all may be deducted in the year in which expended. While not necessary for determination of this case, it is interesting to note that the Board of Tax Appeals has decided that such costs are capital investments, and that the Commissioner has no power by regulation to change their character and to permit their deduction as current expenses (*Old Farmers Oil Co.* v. *Commissioner*, 12 B. T. A. 203, 217). This regulation further provides that if these expenses are charged to invested capital, in so far as they are represented by physical property, they may be taken into account in determining a reasonable allowance for depreciation.

Article 225 of the Regulations provides that in addition to and apart from the deduction allowable for depletion there will be permitted a reasonable allowance for depreciation of property such as machinery, tools, equipment, pipe, etc., so far as not in conflict with the option exercised by the taxpayer under Article 223, and that the amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired, and that where it can be shown that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal, useful life of the physical property, this amount annually deductible for depreciation may be based upon the length of life of the deposit.

In these regulations, the Treasury has expressly recognized the mandatory requirement of Congress that there shall be an

allowance not only for depletion but also for depreciation, and it is respectfully submitted that a proper construction of these regulations recognizes the true distinction between the allowance for depletion and depreciation, namely, that depletion should be allowed for the lessening in value of the oil deposits which were placed there by Nature, and depreciation shall be allowed for the lessening in value of all improvements placed there by man. Such a construction is consistent with the express words and purpose of the statute, also with the true and well understood meaning of the terms depletion and depreciation, and with the decision of this court in the case of *United States* v. *Ludey*, 274 U. S. 295.

The facts in this case show that the expenses upon which respondent has been allowed by the Court of Claims a deduction for depreciation are all the costs of erecting and constructing a completed oil well, which includes not only the costs of the material and equipment, and the costs of hauling, freight, etc., upon such materials, but also the cost of drilling the oil well.

The regulations permit a depreciation upon expenditures represented by physical properties. *Physical* has been defined as relating to what is material and perceived by the senses, specifically pertaining to the material part or the structure of an organized being as opposed to what is mental or moral. It is also defined as that which is external, obvious to the senses and cognizable through a bodily or material organization.

Physical properties mean those properties which can be seen, and which are obvious to the senses, as opposed to those which are mental or moral and have no definite existence.

The respondent submits that a completed oil well is a physical thing. It is also an improvement or an addition to the property. It can be seen. It can be touched. It performs a useful function or duty. It is obvious to the senses. It has no purely mental, moral, or intangible characteristics. An oil well consists of an aggregation of physical things such as pipes, sleeves, derricks, pumps, various articles of steel, timber, etc., and before the oil well as such and as a completed structure is brought into existence all of these component parts must be put together to produce the ultimate physical object which is the completed oil well. Without the labor of drilling the hole,

the fuel to run the drill, the freight, and the hauling of the casings, and the materials themselves, and all of such things for which these expenditures were incurred, these objects would never produce a completed oil well which, as above stated, is the ultimate physical object or property here involved, and such parts would always remain only component parts thereof, scattered at distant points over the face of the earth.

A producing oil well is a physical property. The mere fact that a portion thereof extends into the bowels of the earth does not prevent it from being a physical object or physical property. It is a structure and is the result of a construction project. The hole in the ground is as much a part of the completed oil well as any other component part such as casings, derricks, etc. Without the hole in the ground the oil well could not be completed or brought into existence.

It is respectfully submitted that even a mere hole in the ground which is constructed by man is a physical object. When constructed for the purpose of being used as an oil well or even a well for drinking water, it is a physical thing, it becomes physical property, and is an improvement upon the premises.

The Board of Tax Appeals in *Jergins Trust Co.* v. *Commissioner*, 22 B. T. A. 551, had under consideration this very question and decided in accordance with the contentions of the respondent in the case at bar. Remarks by the Board in that case are especially interesting and persuasive. Such remarks are in part as follows (p. 562):

"The final contention of petitioner is that respondent erred in adding its drilling and development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that this is the proper solution of the problem. Compare *Consolidated Mutual Oil Company*, 2 B. T. A. 1067, *Old Farmers Oil Company*, 12 B. T. A. 203. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion

unit. Ordinarily, where there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements, * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States* v. *Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves.

"The Commissioner relies upon Article 223 of Regulations 62 which provides:

> " 'Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation.* * * *' (Italics supplied.)

"If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be

depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that 'are represented by physical property while other costs were not.' The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.' The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling 'in connection with development and drilling.' This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures."

This case was recently reversed by the United States Circuit Court of Appeals for the Ninth Circuit (decision as yet unreported), but the reversal was upon other grounds, and the conclusion by the Board of Tax Appeals upon the question of depreciation was not discussed or disturbed.

The Board of Tax Appeals has also followed this ruling in *Petroleum Exploration* v. *Commissioner*, 23 B. T. A. 890; *Ziegler, et al.* v. *Commissioner*, 23 B. T. A. 1091; and *P. M. K. Petroleum Company* v. *Commissioner*, 24 B. T. A. 360. The United States Circuit Court of Appeals for the Fourth Circuit has reversed the Board of Tax Appeals in the *Petroleum Exploration* case. The opinion is not reported but a copy is printed as an appendix to the petition for writ of certiorari herein. This decision will be hereinafter discussed.

The Government contends that the cost of drilling the hole

in the ground is more directly related to the value of the mineral deposit and therefore should be returned through the allowance for depletion instead of the allowance for depreciation, and that the hole in the ground does not wear out or become exhausted and therefore can not be made the subject of depreciation. This is an arbitrary attitude and an attempt to avoid the application of the general rules, and would have the effect in this case of defeating the purpose of the statute.

The usefulness of the hole in the ground does become exhausted and wears out. The hole in the ground has no further use after the oil is removed, and the statute required a reasonable allowance for "the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." It also required a depreciation of improvements. The exhaustion of the useful life of the hole in the ground comes clearly within these requirements, and as we have heretofore shown comes clearly within the proper construction of the regulations requiring an allowance for depreciation of expenditures made for physical properties. The concessions by the Government in the Court of Claims in this case clearly demonstrate the correctness of respondent's contention and the error of the Government's position. Although the Commissioner of Internal Revenue had refused to allow a depreciation upon the cost of the freight and hauling of the casing, material, and equipment, the Government conceded in the Court of Claims that such an allowance for depreciation should be made. It is interesting to note that although the Government conceded this item in the Court of Claims it apparently made no such concession in the *Petroleum Exploration* case in the Fourth Circuit because the Court of Appeals in the last paragraph of the decision in that case emphatically determines that these costs should be made the subject of an allowance for depreciation. The cost of freight upon a casing, and the cost of hauling that casing from the railroad to the site of the oil well is just as intimately and closely connected with the oil deposit as is the cost of drilling the hole in the ground. That expenditure can have no useful life or purpose other than in connection with that particular oil well. When that oil well to which the casing has been hauled and delivered becomes entirely

depleted, the value of the expenditure for freight and hauling is entirely gone. That expenditure does not wear out, nor does it have a salvage value after the life of the oil well, but the useful life of that expenditure is entirely exhausted when the oil well becomes entirely depleted. There is no sound reason why a deduction for depreciation upon the cost of freight and hauling of materials and equipment should be allowed, and a deduction upon the cost of drilling the hole should be denied. This inconsistency by the Government proves the error of its contention and the correctness of the contention by respondent.

It is respectfully submitted that the completed oil well is an improvement as the term is used in the statute, and a physical property as the term is used in the regulations, and that an allowance for depreciation should be made for all of the expenditures in the construction of such completed oil well. It is therefore submitted that not only the statute but also a proper construction of the regulations require the allowance of such a deduction, and that the action by the Commissioner in denying a deduction upon the cost of drilling a hole is inconsistent both with the statute and with the regulation.

If the Regulations do not Require or Permit a Depreciation of the Drilling Costs, these Regulations are Contrary to the Statute and are Invalid.

While we feel confident that the regulations not only permit but require an allowance for depreciation upon drilling costs, we contend that if these regulations do not require or permit of such a deduction the regulations are in conflict with the express provisions of the statute and are therefore beyond the power of the Commissioner, and are invalid.

We have heretofore shown that the statute (Section 234 (a) (8)) specifically provides that in the case of oil and gas wells there should be made "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case"; we have also shown that the words depreciation and depletion are separate and distinct and have well defined meanings. This principle was recognized

and announced by the decision of the Supreme Court in the case of *United States* v. *Ludey*, 274 U. S. 295. In view of the fact that some of the earlier Revenue Acts did not contain provisions for depletion and that such conditions resulted in an injustice, and that the later Revenue Acts contained specific provisions for depletion and also provided for depreciation (see *Ludey* case at p. 302), it can not be seriously contended that Congress in any manner confused the two terms.

In considering this question, we should also bear in mind the rules of statutory construction to the effect that the primary rule is to ascertain and give effect to the intent of the legislative body, and that where the language of a statute is plain and unambiguous and conveys a clear and definite meaning, resort must not be had to rules of construction, but the statute must be given its plain and obvious meaning (*United States* v. *Missouri Pacific R. Co.*, 278 U. S. 269). Courts will not legislate but will construe the statutes as framed by the Congress. The words will be considered as used in their ordinary sense and the literal meaning of a statute will not be departed from by the courts unless a literal construction produces an absurdity so gross as to shock the general moral and common sense (*Crooks* v. *Harrelson*, 282 U. S. 55).

In dealing with taxing statutes, the general rule requiring adherence to the letter of a statute applies with peculiar strictness. See *Crooks* v. *Harrelson*, *supra*, at p. 61.

In the case of *United States* v. *Merriam*, 263 U. S. 179, 187–188, the court said that in statutes levying taxes the literal meaning of the words employed is most important and such statutes are not to be extended by implication beyond the clear import of the language used.

Where, however, the language of a statute is of doubtful meaning, of course the court must construe the ambiguity, but in construing such ambiguity in a tax statute the same must be resolved in favor of the taxpayer and a taxing statute should not be extended by implication beyond the clear import of the language used (*Gould* v. *Gould*, 245 U. S. 151; *United States* v. *Merriam*, 263 U. S. 179, *Reinecke* v. *Trust Company*, 278 U. S. 339).

It is also a well settled rule that the Secretary of the Treasury

can not by his regulations alter or amend a revenue law (*Morrill* v. *Jones*, 106 U. S. 466), and while the regulations made by the Commissioner have the force and effect of statutes if made with the approval of the Secretary of the Treasury and pursuant to statutory authority, yet, if they are not reasonable or are in conflict with the statute, the regulations are invalid (*Burnet* v. *Moore Cotton Mills Company* (C. C. A. 4th), 49 Fed. (2) 59; *Palmer, Trustee*, v. *United States*, 67 C. Cls. 648 at 653, 654).

We respectfully urge that the statute says that both depreciation and depletion shall be allowed. Depreciation has the well established meaning of being the lessening in value of the improvements upon a property, while depletion has the well recognized and established meaning of a diminution of the natural deposits. Depletion of the natural deposits under this statute should not be confused with depreciation, and the depreciation of the improvements should not be confused with the depletion of the natural deposits. The statute is in the conjunctive and requires that both should be allowed. See *Crooks* v. *Harrelson*, *supra*.

We have heretofore shown that these drilling costs become a part of the improvements put upon the property by mankind and are in no manner a part of the natural reserve or the mineral deposit. They are separate and distinct therefrom and any act of the Commissioner, whether by regulation or otherwise, that attempts to prevent the return of the investment in such improvements by way of depreciation is contrary to the statute and therefore under the decisions cited is invalid and must be ignored.

An examination of other provisions of Regulations 69 dealing with the question of depreciation and depletion conclusively shows that the Commissioner had in mind the distinction between depreciation and depletion and the reasons fundamental to each, and that if the regulations are not given the construction for which we have heretofore contended, it is submitted that they become inconsistent with each other as well as with the express provisions of the statute.

In Article 161, of Regulations 69, it is stated that:

"*Depreciation.*—A reasonable allowance for the exhaustion,

wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonable consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with section 204 and articles 1591–1603. Due regard must also be given to expenditures for current upkeep."
* * *

Article 162 provides that:

"*Depreciable property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the statute. (See sections 204 (c), 214 (a) (9), and 234 (a) (8) and articles 201–237 and 1602)."
* * *

Article 163 provides that:

"*Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only

a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner."

Article 164 provides that:

"*Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See article 1602.)" * * *

Article 165 provides that:

"*Method of computing depreciation allowance.*—The capital sum to be replaced should be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable." * * *

Article 201 provides that:

"*Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions, but not including land values for purposes other than the extraction of minerals. * * *

"When used in these articles (201–237) covering depletion and depreciation—* * *

"(c) A 'mineral property' is the mineral deposit, the de-

velopment and plant necessary for its extraction, and so much of the surface only as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The value of a mineral deposit is the value of the mineral property, less the value of the plant and equipment, and less the value of the surface of the land for purposes other than mineral production. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

"(e) 'Minerals' include ores of the metals, coal, oil, gas. * * *

"(g) 'Depletion or depreciation sustained' means (except in cases where a discovery value has been established, as to which see (h) below) depletion or depreciation actually sustained, whether legally allowable or not, based on the cost or value as at the basic date, as the case may be."

Article 203 provides that:

"*Amount returnable through depletion and depreciation deductions in the case of lessee.*—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computations of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property."

Article 207 provides the method for the determination of the fair market value of oil and gas properties, and, among other things, provides that:

"* * * The development cost includes expenditures for drilling wells to maintain or increase production or to develop

additional unproven areas, and the cost of improvements necessary to the development of the property, such as roads, warehouses, water lines, etc. The operating cost includes all current expenditures for producing, preparing, and marketing the oil and/or gas produces, such as pumping oil wells, repairs of oil or gas wells, cleaning sanded wells, shooting wells, redrilling old wells, labor and supplies for collecting oil, repairs to separators, pumps, and collecting lines, repairs to buildings and structures, repairs to field tools, equipment, fixtures and machinery, superintendence, other field expenditures, overhead, etc. (due consideration being given to taxes), exclusive of allowable capital additions as defined in article 223 and deductions for depreciation and depletion. The cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returnable to the taxpayer free from tax." * * *

From the above it will be seen that the Commissioner of Internal Revenue has recognized the distinction between depreciation and depletion. He has also recognized the fundamental basis of the theory of depreciation and has specifically said in Article 162 that it does not apply to bodies of minerals which through the process of removal suffer depletion. He has also said that it is the intention to permit the return of the capital sum invested in property used in business and that this sum should be charged off over the useful life of the property either in equal annual installments or by an apportionment of the capital sum over the units of production.

In Article 201 he again expressly recognizes the distinction between depreciation and depletion where he says that in the case of mines, oil and gas wells, the taxpayers should be allowed as a deduction in computing net income "in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements." He then goes on and explains the theory that the depletion shall cover the mineral deposits.

It is respectfully submitted that if it should be held that under the provisions of Articles 221, 223 and 225 of Regulations 69 these costs can not be made the subject of depreciation, then these articles become inconsistent with the other articles of Regulations 69 which have just been discussed, and it is

further submitted that Articles 221, 223 and 225 so construed become inconsistent with the express words of the statute which require the allowance of both depreciation and depletion and that such depreciation and depletion are separate and distinct and have been so recognized by the Commissioner of Internal Revenue in other articles of these same regulations.

It is manifest that Congress intended that the operation of the provision with reference to depreciation and depletion should permit the return of the capital investment of the taxpayer over the period of years of operation. The Regulations above quoted clearly recognize and state this principle (article 201). It is equally manifest that an oil well as well as the investment therein will have no useful life after the oil in paying quantities has been exhausted. The arbitrary allowance for depletion is 27½ per cent of the income for a given year. This bears absolutely no relation to the amount of money expended in the drilling of wells upon the property, but as the regulations of the Treasury Department will reveal, and as the statements by the courts in the decided cases will show, was an arbitrary figure which from experience was believed just and was arrived at in order to avoid the many difficulties in the ascertainment of depletion quantities and discovery values, but it was never meant to have any application to the recovery of the capital investment in the cost of the construction of oil wells and such operating properties.

In the case at bar, it will be seen that in the year 1926 out of an estimated oil reserve of 825,253.33 barrels upon the property known as the Emmons Lease, there was extracted a total of 641,596.59 barrels of oil (R. 6). It will thus be seen that to deny the respondent the right to recover its capital investment in improvements by way of depreciation and to compel it to rely upon its chances of recovering the same by way of depletion will work a particular hardship in this case. In the first place, the deduction for depletion has no reference to or connection with the amount of the cost of the improvements. In the second place, the 27½ per cent is given upon the income for the year, whereas during the current year approximately ¾ of the oil reserve was removed. These two facts alone show that Congress must have had in mind the thing for which we

have above contended, namely, that depletion and depreciation should be allowed according to their well understood meanings and should not in any manner be confused.

The Decision by the United States Circuit Court of Appeals for the Fourth Circuit in Petroleum Exploration v. *Commissioner is Erroneous.*

The decision of the United States Circuit Court of Appeals for the Fourth Circuit in the case of *Commissioner* v. *Petroleum Exploration* (not yet reported, but a copy is printed as an appendix to the petition for certiorari herein) is based upon the following theory:

1. The taxpayer had the option of charging these drilling expenses as operating or current expense and deducting them all in the year they were expended or of charging them to capital investment and recovering them through depreciation, but when it exercised the option and charged them to invested capital it must have elected to recover only those portions which the regulations permitted, and this election is binding.

2. The cost of drilling the hole is not properly subject to depreciation because there is no wear and tear, and

3. The long and consistent administrative construction as evidenced by the Regulations is binding upon the taxpayer.

The Court for the Fourth Circuit contends that Article 223 of the Regulations gave the taxpayer the option to either charge the expenditures made in drilling the hole to current expense and deduct them all in the year which made or to charge them to capital account and secure a return of such portions as were permitted by the regulations for the deductions for depletion and depreciation, and that when the taxpayer elected to charge these to capital expenditures he assumed all the obligations and burdens of the regulations and must abide strictly by the same.

In the first place, the respondent contends that, as has been heretofore shown, a proper construction of the regulations requires the deduction for depreciation upon the cost of drilling the hole as well as all the other costs of the completed oil well.

In the second place, if it did not require such a construction, certainly the taxpayer was entitled to believe that under this regulation he would be permitted to recover all of his expenditures and therefore can not be charged with an election. Further than this, the taxpayer really did not have the right of election since, as has been shown in the case of *Old Farmers Oil Company* v. *Commissioner*, 12 B. T. A. 203, and *Consolidated Mutual Oil Company* v. *Commissioner*, 2 B. T. A. 1067, as well as the case of *Jergins Trust Co.* v. *Commissioner*, 22 B. T. A. 551, the Board of Tax Appeals has held that these expenses are not properly chargeable as current or operating expenses, and the Commissioner has no right to permit such a charge, but they are properly capital investments and should be so charged. In the next place, if the expenditures were made in the first year of the operation of a company in which there would no doubt not be sufficient income to permit the charging off of the entire investment, the taxpayer could only recover the same through a process of a charge to capital investment and deductions for depreciation, and under the regulations this election once made can not be changed. Therefore, the taxpayer did not in reality have any such an election and this hypothesis of the opinion by the Court for the Fourth Circuit is erroneous.

The Circuit Court of Appeals for the Fourth Circuit then holds that these costs should be recovered through depletion and not through a deduction for depreciation. It is respectfully submitted that what has been heretofore said in the discussion of the other portions of this brief clearly establishes that this theory is unsound. The court points out that if the contention of the respondent is sustained, then Article 223 is robbed of any meaning since there is no expense whatever connected with an oil well except as to the exploration of the property which would be included in the deduction for depletion.

It is respectfully submitted that the depletion deduction was intended to cover only the value of the mineral deposit, and that the contention of the respondent in this case leaves such intention entirely operative. The flat percentage was fixed in order to do away with the difficulties attendant upon the discovery value and that is in no manner interfered with by

the decision of the Court of Claims. Article 223 has the full meaning which Congress intended consistent with the proper construction of the statute and the intention of Congress.

The Circuit Court of Appeals for the Fourth Circuit then suggests that the regulations have the force and effect of law as well as the implied approval by Congress, and that the long and consistent administrative construction of the statute as given in these regulations should be upheld by the courts. The respondent recognizes the rule of law that a long and consistent administrative construction of a statute will be given respectful consideration by the court, but as has been heretofore shown it is respectfully submitted that the construction of the regulations now contended for are entirely at variance and inconsistent with the statute. The rule of law is equally familiar that in such circumstances the statute must prevail.

Further than this, there was no such long and consistent administrative construction as would require the court to uphold these regulations in this case, nor can it be said that such regulations were impliedly approved by Congress. As has been heretofore shown, we believe that a proper construction of the regulations sustains the contention of the respondent. As there is no ambiguity in the statute, therefore the regulations construing the same can not in any way vary the terms of the statute. The regulations under the Revenue Act of 1926 are not of long standing, nor are they uniform. Before the Revenue Act of 1926, depletion was based upon a discovery value as the rate of exhaustion. Therefore, prior to this act, so far as the costs of the kind here involved were concerned, it made no difference whether they were allowed as depreciation or depletion. The full amount of such costs could be ultimately recovered upon the basis of exhaustion, but the Revenue Act of 1926 made radical changes in the law with reference to the depletion of oil wells, and did not base such depletion upon a discovery value or the rate of exhaustion, but based the amount of allowable depletion each year upon a flat percentage of the income which had absolutely no relation to value or costs of the property or to the rate of exhaustion. To say that Congress and the Revenue Act of 1926 adopted the regulations

previously existing, requires a wild stretch of the imagination. At that time, the existing regulations dealt with a question of depletion involving the cost or value of the property and the rate of exhaustion. The new act changed all of this and placed depletion upon an entirely different basis. The assumption that Congress adopted such existing regulations is not justified. The courts will not give these regulations the same weight that they would have been given had the law not been so radically changed. The regulations must be tested upon their own merits, and when so tested they are found either to justify the deductions claimed by the respondent or else to be inconsistent with the new statute.

CONCLUSION.

For the reasons heretofore set forth, it is respectfully submitted that the petition for writ of certiorari should be denied.

Respectfully submitted,

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Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 434.

THE UNITED STATES, PETITIONER,

v.

DAKOTA-MONTANA OIL COMPANY.

On Writ of Certiorari to the Court of Claims.

BRIEF ON BEHALF OF RESPONDENT.

HERMAN J. GALLOWAY,
LOUIS P. DONOVAN,
Attorneys for Respondent.

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Supreme Court of the United States.

October Term, 1932.

No. 434.

THE UNITED STATES, *Petitioner,*
v.
DAKOTA-MONTANA OIL COMPANY.

On Writ of Certiorari to the Court of Claims.

BRIEF FOR THE RESPONDENT.

OPINION BELOW.

The findings of fact and the opinion by the Court of Claims are reported in 59 Fed. (2d) 853.

JURISDICTION.

The judgment of the Court of Claims was rendered on July 5, 1932 (R. 16). Petition for writ of certiorari was filed on October 5, 1932 (R. 16). Jurisdiction is invoked under the authority of Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. The writ of certiorari was granted on November 14, 1932 (R. 17).

QUESTION PRESENTED.

Whether under the Revenue Act of 1926 an allowance should be made for depreciation upon the costs of drilling oil wells, the wells upon which the expenditures were so made resulting in producing wells, the production of oil from

such wells being included in the income for the taxable year involved and the expenditures for the drilling costs having been capitalized?

THE STATUTES AND TREASURY REGULATIONS.

The pertinent portions of the Revenue Act of 1926 (Ch. 27, 44 Stat. 9, 16, 41) are as follows:

"Sec. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—* * *

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence:

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." * * *

The following articles of Regulations 69, promulgated under the Revenue Act of 1926, are pertinent:

"DEDUCTIONS ALLOWED CORPORATIONS.

"Art. 561. *Allowable deductions.*—In general the deductions from gross income allowed corporations are the same as allowed individuals, * * *. Particularly, * * * as to

depreciation, see articles 161–170; as to depletion, see articles 201–237; * * *."

"Art. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

"Art. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation * * *."

"Art. 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)"

STATEMENT OF FACTS.

The respondent constructed producing oil wells and charged the entire cost of such construction to invested capital.

The Government has attempted to segregate the entire cost of constructing the completed oil well into three classes of expenditures as follows:

1. The cost of equipment and materials;
2. The cost of freight, hauling, and installing equipment and materials, and
3. The cost of drilling the wells, including the labor, fuel, etc., in such drilling.

The Commissioner of Internal Revenue then allowed a depreciation only upon the costs of the equipment and materials and refused to allow a depreciation upon the other two elements of cost of constructing a completed oil well.

After suit was brought in the Court of Claims to recover the increased taxes paid because of the disallowance of depreciation on the other tw items of cost, the Government conceded in the Court of Claims that depreciation should have been allowed upon the second item of cost, namely, the cost of freight, hauling, and installing the equipment and materials (R. 10.) This item alone results in an overpayment of tax in the sum of $8,420.21, plus interest as provided by law, which sum was included in the judgment for respondent in this case (R. 9).

The Government apparently did not make the same concession in the case of *Burnet, Commissioner*, v. *Petroleum Exploration*, 61 Fed. (2d) 273, since the court in that case expressly decided that such costs should be depreciated (see page 277).

The Government refused to allow any depreciation upon the third class of costs of constructing a producing oil well and the Court of Claims disagreed with this action and included in its judgment the increased taxes paid because of this disallowance.

In the *Petroleum Exploration* case (*supra*) the Commissioner also disallowed any depreciation upon this third class

of costs. The Board of Tax Appeals (23 B. T. A. 890) disagreed with the disallowance, but the Circuit Court of Appeals for the Fourth Circuit (61 Fed. (2d) 273) agreed that the Commissioner was right in not allowing any depreciation upon this third class of costs and in this respect reversed the decision of the Board of Tax Appeals.

The pertinent facts in the case now before this court as such facts were found by the Court of Claims (R. 5–9) are as follows:

The respondent, a North Dakota corporation, during the pertinent times was engaged in developing and operating oil properties, including the procuring of leases on oil lands, drilling, owning and operating oil wells and building, erecting, constructing and owning the necessary camps and equipment for the construction and operation of oil wells. It kept its books and made its income tax return for the calendar year 1926 on an accrual basis (R. 5). During the years 1923 to 1926, both inclusive, respondent expended a large sum of money for labor, fuel, hauling, freight, supplies, material and equipment used in drilling oil wells, casing the same, erecting derricks and camps, and equipment for the operation of such wells, and for all items of cost in the drilling and completion of producing oil wells ready to connect the same to a pipe line (R. 5). The findings of fact show the amounts spent each year for the following separate divisions of expense: (1) Cost of equipment and materials; (2) Cost of freight, hauling, and installing equipment and materials, and (3) Total cost of drilling, such as fuel, labor, etc. (R. 5). All of these expenditures were capitalized by respondent and included in its invested capital. The productive life of all of these producing wells, the expenditures for which were so capitalized, was more than one year (R. 6). The findings of fact also show the estimated oil reserves on the properties upon which these expenditures were made during the pertinent years, and show the amount of oil produced from such properties during the calendar year 1926 (R. 6).

In the computation of its income tax for the year 1926 the respondent claimed a deduction of 27½ per cent of its

gross income from these properties during the taxable year for depletion in accordance with the provisions of the statute, and also claimed a depreciation upon a unit of production basis upon the total amount expended in the drilling and completion of such producing oil wells (R. 7). The Commissioner of Internal Revenue then allowed the deduction for depletion as claimed, but allowed a deduction for depreciation only upon (1) the costs of the equipment and materials and rejected the claim for a depreciation upon the cost of (2) freight, hauling, and installing equipment and materials, and (3) the total cost of drilling, including the labor, fuel, etc. (R. 7).

The respondent then brought this action in the Court of Claims to recover the tax imposed and collected by the Government because of the disallowance of the depreciation claimed, and the Government conceded in the Court of Claims that an allowance for depreciation should be made not only upon the cost of equipment and materials which the Government had previously allowed but also that an allowance for depreciation should be made upon the cost of freight, hauling and installing of the equipment and materials (R. 10), which concession resulted in an admitted overpayment of tax by respondent in the sum of $8,420.21 (R. 9). The Government, however, contended that the actual cost of drilling the well, including the labor, fuel, etc., that is the cost of putting the drill hole in the ground, should not be made the subject of depreciation, but was covered by the allowance for depletion (R. 10). The Court of Claims determined that not only (1) the costs of the equipment and materials and (2) the cost of the hauling, freight, installing, etc., of the equipment and materials should be subjected to an allowance for depreciation, but that the entire cost of creating the producing oil well including (3) the drilling costs should be made the subject of an allowance for depreciation (R. 9 to 14) and rendered its judgment accordingly.

During the calendar years 1922, 1923, and 1924, the respondent had charged as operating costs certain expenditures made by it for early and preliminary costs incident to the oil leases and preliminary to the drilling, construction, and

completion of the oil wells (R. 8). The Government required the respondent to set up said expenditures in its tax returns for the calendar year 1926 as capital investments, and accordingly increased respondent's capital investment for that calendar year in the amount so set up (R. 8). The respondent claimed a deduction for depreciation upon these expenditures and the Court of Claims allowed such depreciation. The Court of Claims rendered judgment for the respondent for the principal sum of $19,096.12 (R. 16), which included the sum of $8,420.21 conceded by the Government.

SUMMARY OF ARGUMENT.

The statute requires the allowance of a depreciation upon the costs here in question. A proper interpretation of the Regulations also requires the allowance of such depreciation. They both require the allowance of depreciation upon improvements and physical properties. A completed oil well should be considered as a whole and a unit and as such is both an improvement and a physical property. It is arbitrary and unreasonable to attempt to separate into classes the costs of constructing a completed oil well and allow a depreciation upon only a part of such costs. If the Regulations do not permit a depreciation upon the costs of drilling the oil well then such regulations are contrary to the statute, unreasonable, arbitrary and inconsistent with other parts of the Regulations and must therefore be disregarded.

ARGUMENT.

I. *Both the statute and the regulations require a depreciation upon the drilling costs.*

It is well recognized that it was the purpose and intent of the Federal income tax laws to lay a tax upon net income only and that the purpose of many of the provisions of the taxing statutes permitting the allowance of deductions from gross income in order to arrive at the net income upon which the tax is to be computed is to exclude from the net income a

return of invested capital and thus not lay a tax upon the return of such invested capital.

It is in accordance with this well established plan that Section 234 (a) (8) of the Revenue Act of 1926 provides that:

"(a) In computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as deductions:

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *"

This statute expressly requires that both depletion and depreciation shall be allowed. There is no uncertainty or ambiguity in such provision but it is definite and mandatory.

It is also the purpose of this section to allow a depreciation upon the costs of the improvements made by man upon the property so as to permit a return by way of depreciation allowances of the capital invested in the same and also to permit a depletion upon the value of the oil deposit placed there by Nature, the depletion allowance taking care of the actual cost of the deposit and making also an allowance for the discovery value covered by prior Revenue Acts.

Depletion and depreciation are separate and distinct. Each has a well defined meaning. The word "depletion" is derived from the Latin word "deplere," meaning to empty or exhaust. "Depreciation" is derived from the Latin word "depretaire," meaning to lessen in price or value. The word "improvement" also has a well known meaning, and is defined as being that by which the value of anything is increased or as an amelioration of the condition of property affected by the expenditure of labor or money for the purpose of rendering it useful for other purposes than those for which it was originally used, or more useful for the same purpose.

Applying these definitions to the statute, it means that there shall be in the case of oil wells or other natural deposits

a reasonable allowance for the emptying or exhaustion of the deposits, and a reasonable allowance for the lessening in value of the increased value of the property resulting from the expenditure of labor or money. The decision by this court in the case of *United States* v. *Ludey*, 274 U. S. 295, clearly shows that such definition and meaning was that which Congress had in mind in the Revenue Acts relating to oil wells. At p. 300 the court said:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. * * *"

Again, on p. 302, the court said:

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion."

The Supreme Court then pointed out that the Corporation Tax Law of 1909 contained no provision for deductions on account of depletion of mineral reserves and, at page 303, said:

"The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 and all later Acts for some deduction on account of depletion in determining the amount of the taxable income from mines. It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties. The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks. It is argued that, because oil is a fugacious mineral, it can not be known that the reserve has been diminished by the operation of wells. Perhaps some land may be discovered which, like the Widow's cruse, will afford an inexhaustible supply of oil. But the common experience of man has been that oil wells, and the territory in which they are sunk, become exhausted in time. Congress in providing for the deduction for depletion of oil wells acted on that experience. Compare *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. In essence, the deduction for depletion does not differ from the deduction for depreciation."

In the *Ludey* case this court holds that the allowance for depletion was to represent a reduction in the mineral content of the reserve, and was separate from a depreciation of improvements. The court points out that the proviso in the law limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction was to be regarded as a return of capital and not as a special bonus for enterprise and willingness to assume risks. The *Ludey* case was decided under the Revenue Act of 1916. In the Revenue Act of 1918 Congress went further and provided for a depletion allowance based upon a discovery value which included something in the nature of a special bonus for enterprise and willingness to assume risks. After that the depletion allowance was not confined to a return of capital invested in the oil reserves.

Under the Revenue Act of 1918 and all acts subsequent thereto up to the Revenue Act of 1926, the following procedure was followed in determining the basis of the depletion allowance: (a) If the property was acquired prior to March 1, 1913, then the fair market value on that date might be used in lieu of the cost of the property; and (b) if the oil was discovered on or after March 1, 1913, where the fair market value was materially disproportionate to the cost, the depletion allowance was based upon the fair market value at the date of discovery or within thirty days thereafter.

(See Sections 214 (a) (10) of the Revenue Act of 1918, also Sections 201 to 206 of Regulations 45.)

In the Revenue Act of 1921 it was provided that the allowance for depletion should not exceed the net income for the year and in the Revenue Act of 1924 there was placed a limitation that the allowance for depletion should not exceed fifty per cent of the net income for the year.

The Revenue Act of 1926 changed this allowance for depletion. Great difficulty had been experienced in the determination of the so-called discovery value and in order to simplify the matter Congress provided for a flat and arbitrary deduction of 27½ per cent of the gross income for depletion. This was to cover the value of the mineral deposit, including the discovery value.

All of this is very clearly shown by the legislative history of the Revenue Act of 1926. It is well settled that reports of committees of the House and Senate as well as explanatory statements in the nature of a supplemental report made by the committee members in charge of a bill in the course of passage may be considered by the courts and regarded as an exposition of the legislative intent and purpose of the law-making body.

(*Binns* v. *United States*, 194 U. S. 486, 495; *Duplex Co.* v. *Deering*, 254 U. S. 443, 474, 475.)

The Revenue Act of 1926 was H. R. 1 in the 69th Congress, 1st Session. As the bill was reported to the House, it contained provisions allowing a depletion upon discovery value, but limiting that to areas outside of a square of 160 acres, using the producing well as the center (House Report No. 1,

69th Congress, 1st Session, page 6). But in the Senate the bill was reported to allow a flat deduction of 25% of gross income instead of the depletion based on discovery value (Senate Report No. 52, 69th Congress, 1st Session, page 17, 18). This action is there explained as follows:

"Section 204 (c) and (d): The basic changes made in the discovery depletion provision by the House were explained in a Report of the Ways and Means Committee, as follows:

" 'The committee feels that the deduction for discovery depletion should be limited somewhat further than it was limited in the revenue act of 1924, and in addition that there should be incorporated in the act the Treasury regulation defining a proven area. Under the existing law, discovery depletion is allowable to one who brings in a well upon property proven at the time the well is brought in, if at the time it was purchased by the taxpayer it was not proven. Obviously the benefits of discovery depletion, the purpose of which was to encourage the wildcatter or pioneer, should be limited to those who make an actual discovery. Furthermore, in the interest of certainty and clarity, it is thought advisable to incorporate in the law a definition of what is a proven area. With these two objects in mind the committee recommends the amendments of the discovery provision contained in the bill. The new subdivision provides that in the case of oil and gas wells discovered by the taxpayer on and after January 1, 1925, in an area not proven at the date of such discovery, where the fair market value of the property is materially disproportionate to cost, the basis for depletion shall be the fair market value at the date of discovery or within 30 days thereafter of the property proven by such discovery and included within the taxpayer's tracts or leases. The subdivision further provides that in the case of oil or gas wells, each well producing oil or gas in commercial quantities shall be considered as having proven at least that portion of the productive sand, zone, or reservoir which is included in the square surface area of 160 acres having as its center the mouth of such well. The amendment further provides that in case two or more persons enter into an agreement whereby the cost of the well shall be shared if oil or gas in commercial quantities is not found, such well shall not be considered as having proven any part of the tract or lease held by such other persons. The discovery depletion deduction limitation of an amount not in excess of 50 per cent of the net income of the taxpayer

from the property upon which the discovery was made, provided in existing law, is retained in this provision.'

"The amendment proposed by your committee makes only one basic change in the discovery depletion provision of existing law so far as such provision relates to mines. It enlarges the present discovery provision in the case of mines by permitting a deduction for discovery value in the case of discoveries of minerals discovered or proven in an existing mine or mining tract after February 28, 1913, not included in any prior valuation.

"The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained."

Senator Reed, a member of the Senate Committee which reported the bill and who was in charge of the same on the floor of the Senate, said:

"Mr. REED of Pennsylvania. No; it would not happen. If we were to calculate the depletion at some fixed percentage of the cost of the property that would not occur. But ever since early war days Congress has followed the policy of allowing what they call discovery value for both oil and gas wells and for minerals. It is perfectly obvious that if I buy an acre of land in the Rocky Mountains and pay $10 an acre for it, and then, by hard work, discover a rich deposit of gold in it, the calculation of my depletion on the original $10 basis would not allow me any adequate return for my real capital. So, in allowing what is called discovery value, Congress and the bureau have tried to get at the real but the unknown value of the property owned by the taxpayer.

"Whether it is wise to handle the problem in that way or not I am not entirely persuaded. It has led to some large deductions from income, but to refuse to do it and to calculate the depletion on the original cost is not fair, either, because in these uncertain industries there is much property which is bound to be worthless, on which the taxpayer really

makes a dead loss; but there is no production and consequently no depletion from that property.

"Mr. KING. And no tax.

"Mr. REED of Pennsylvania. And no tax.

"Mr. COUZENS. Does the Senator know of any other industry where that is allowed?

"Mr. REED of Pennsylvania. The production of minerals is the only one that I know of—either oil or gas or solid minerals. It is only in the production of such minerals that the element of uncertainty enters so largely."

Congressional Record, Vol. 67, part 4, page 3762 (69th Congress, First Session). This is further emphasized by the provisions of Regulation 45 issued under the Revenue Act of 1918, especially Articles 201 and 219.

It is clearly shown by the foregoing that discovery value and depletion based thereon was never intended to be limited to a return of the money actually invested in the particular oil reserves upon which the allowance is made. It was realized that there was a peculiar situation in the oil industry which had to be dealt with differently from other industries. For example, the oil man may acquire a piece of land or an oil lease on unproven land for $10; he may spend $5,000 in exploration and investigation and $100,000 in drilling oil wells and have only dry holes which produce no oil. Therefore, such a pioneer would have no income from which to recoup his invested capital by way of depletion and depreciation. He may well continue this program and after many unsuccessful attempts get a well that after it is brought into production has a value of $1,000,000. If, however, as the oil is produced he is to be allowed a depletion upon the cost of $10 plus the $5,000 exploration and investigation expense and a depreciation upon the cost of constructing the well, he will be taxed upon a very large sum each year as the oil is produced and never have any opportunity to recoup, either by way of depletion or depreciation, the cost of the unsuccessful wells which were in reality only a part of the costs of exploration preliminary to the finding of the producing well. Therefore, in order to encourage the bringing into existence of new wells and new oil production,

the Revenue Act of 1918 provided for a depletion upon a discovery value which had no relation to the money spent on the producing well on which the allowance was made.

It is respectfully submitted that Congress specifically provided in Section 234 of the Revenue Act of 1926, that there should be an allowance for depletion or exhaustion of the natural deposits, that is, an allowance for the diminution of that which had been placed upon the property by Nature. Congress further provided that there must be a reasonable allowance for the depreciation of improvements, that is, an allowance for the diminution in value of that which had been placed upon the property by man.

It is further submitted that a proper construction of the regulations issued by the Treasury Department is not at all in conflict with this expressed purpose and intent of Congress, but is in full accord with the same.

The Commissioner in Article 221 of the Regulations provides that the taxpayer may deduct on account of depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year. He thus clearly recognizes the necessity and correctness of an allowance for depletion and in his determination of the method of arriving at the amount of depletion he merely adopts the method specifically provided for the determination of such amount in Section 204 (c) (2) of the Revenue Act of 1926.

Article 223 of the Regulations undertakes to give to the taxpayer the option of charging drilling costs to operating expenses or to invested capital, and provides that if charged as operating costs all may be deducted in the year in which expended. This regulation further provides that if these expenses are charged to invested capital, in so far as they are represented by physical property, they may be taken into account in determining a reasonable allowance for depreciation. This is a recognition again that there must be an allowance for both depreciation and depletion.

Article 225 of the Regulations provides that, in addition to and apart from the deduction allowable for depletion, there will be permitted a deduction of a reasonable allowance for depreciation of physical property such as machinery, tools,

equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under Article 223, and that the amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired, and that where it can be shown that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property then the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. The provision permitting the calculation of depreciation upon the basis of the unit of production is wholly inconsistent with any theory that limits depreciation to wear and tear. It recognizes that the useful life of the investment may come to an end long before there is even any wear or tear but that still the investment should be returned during the useful life regardless of wear and tear.

In these regulations the Treasury had expressly recognized the mandatory requirement by Congress that there shall be allowance not only for depletion but also for depreciation, and it is respectfully submitted that a proper construction of these regulations recognizes the true distinction between the allowance for depletion and depreciation, namely, that depletion should be allowed for the lessening in value of the oil deposits which were placed there by Nature, and depreciation shall be allowed for the lessening in value of all improvements placed there by man. Such a construction is consistent with the express words and purpose of the statute, also with the true and well understood meaning of the terms depletion and depreciation, and with the decision by this court in the case of *United States* v. *Ludey*, 274 U. S. 295.

The facts in this case show that the expenses upon which respondent has been allowed by the Court of Claims a deduction for depreciation are all the costs of erecting and constructing a completed oil well, which includes not only the costs of the material and equipment, and the costs of

hauling, freight, etc., upon such materials, but also the cost of drilling the oil well.

The regulations permit a depreciation upon expenditures represented by physical properties. *Physical* has been defined as relating to what is material and perceived by the senses, specifically pertaining to the material part or the structure of an organized being as opposed to what is mental or moral. It is also defined as that which is external, obvious to the senses and cognizable through a bodily or material organization.

Physical properties mean those properties which can be seen, and which are obvious to the senses, as opposed to those which are mental or moral and have no definite existence.

The Government in the application of the regulations has decided that the completed oil well shall not be considered as a whole and as constituting an improvement as a whole, but has held that the completed oil well as a whole is not a physical property as the term is used in the regulations. It has therefore arbitrarily divided the costs of erecting a completed oil well into three classes. It at first decided that only one class of these costs is represented by physical properties and constitutes improvements upon which depreciation can properly be allowed. Later, the Government conceded n court in this case that another class of costs should be subjected to an allowance for depreciation, but still urged that the drilling costs should not be subjected to depreciation.

The respondent urges that the completed oil well should be considered as a whole and not arbitrarily divided into parts, and that the completed oil well as a whole is an improvement as used in the statute and a physical property as used in the regulations. The respondent further contends that therefore all of the costs of constructing the completed oil well as a whole and as an entirety should be made the subject of a deduction for depreciation.

The respondent submits that a completed oil well is a physical thing. It is also an improvement or an addition to the property. It can be seen. It can be touched. It

performs a useful function or duty. It is obvious to the senses. It has no purely mental, moral, or intangible characteristics. An oil well consists of an aggregation of physical things such as pipes, sleeves, derricks, pumps, various articles of steel, timber, etc., and before the oil well as such and as a completed structure is brought into existence all of these component parts must be brought together and put together to produce the ultimate physical object which is the completed oil well. Without the labor of drilling the hole, the fuel to run the drill, the freight, the hauling of the casings, and the materials themselves, and all of such things for which these expenditures were incurred, these objects would never produce a completed oil well which, as above stated, is the ultimate physical object here involved, but such parts would always remain only component parts thereof scattered at distant points over the face of the earth.

A producing oil well is a physical property. The mere fact that a portion thereof is extended into the bowels of the earth does not prevent it from being a physical object or physical property. It is a structure and is the result of a construction project. The hole in the ground is as much a part of the completed oil well as any other component part such as casings, derricks, etc. Without the hole in the ground the oil well could not be completed or brought into existence.

It is respectfully submitted that even a mere hole in the ground which is constructed by man is a physical object. When constructed for the purpose of being used as an oil well or even as a well for drinking water, it is a physical thing, it becomes physical property, and is an improvement upon the premises.

In the recent case of *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551, the Board of Tax Appeals had for consideration the question whether a deduction should be allowed from income for the years 1922, 1923, and 1924, governed by the Revenue Act of 1924, for depreciation upon these so-called drilling costs, and decided in accordance with the contentions of respondent. Remarks by the Board in that decision are sound and very persuasive. Such remarks (p. 562) are in part as follows:

"The final contention of petitioner is that respondent erred in adding its drilling and development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that this is the proper solution of the problem. Compare *Consolidated Mutual Oil Company*, 2 B. T. A. 1067; *Old Farmers' Oil Company*, 12 B. T. A. 203. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion unit. Ordinarily, where there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States* v. *Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves.

"The Commissioner relies upon Article 223 of Regulations 62 which provides:

" 'Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If in exercising this option the taxpayer* charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *' (Italics supplied.)

If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that "are represented by physical property while other costs were not." The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all "represented by physical property." The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling "in connection with development and drilling." This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment

of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures.

This case was recently reversed by the United States Circuit Court of Appeals for the Ninth Circuit (decision as yet unreported), but the reversal was upon other grounds, and the conclusion by the Board of Tax Appeals upon the question of depreciation was not discussed or disturbed.

The Board of Tax Appeals has also followed this ruling in *Petroleum Exploration* v. *Commissioner*, 23 B. T. A. 890; *Ziegler, et al.* v. *Commissioner*, 23 B. T. A. 1091; and *P. M. K. Petroleum Company* v. *Commissioner*, 24 B. T. A. 360. The United States Circuit Court of Appeals for the Fourth Circuit has reversed the Board of Tax Appeals in the *Petroleum Exploration* case. The opinion is reported at 61 Fed. (2d) 273, and a copy is printed as an appendix to the petition for writ of certiorari herein. This decision will be hereinafter discussed.

The Government contends that the cost of drilling the hole in the ground is more directly related to the value of the mineral deposit and therefore should be returned through the allowance for depletion instead of the allowance for depreciation, and that the hole in the ground does not wear out and therefore can not be made the subject of depreciation. The same theory was followed in the dissenting opinion in the Court of Claims (R. 15) where it was said:

"An oil well, that is, the hole in the ground, like real estate, is not naturally subject to depreciation through wear and tear. Its usefulness is exhausted as the oil is removed, but exhaustion is comprehended in the allowance for depletion. In the ordinary case the statute provides for a reasonable allowance for 'the exhaustion, wear, and tear of property used in the trade or business,' but in the case of oil wells the statute, section 234 (a) (8) of the Revenue Act of 1926, in providing for a deduction for depletion and for wear and tear, states that 'In the case of * * * oil and gas wells * * * a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the

commissioner with the approval of the Secretary.' The costs which may be included in the amount to be used for the purpose of computing the allowance for depreciation must be costs in relation to physical property which is subject to depreciation through wear and tear as distinguished from exhaustion. The deduction for depletion is a special application of the general rule allowing a deduction for exhaustion. The depreciation charge represents the reduction during the year of the capital assets through wear and tear of the plant used. The depletion is likened to the using up, i. e., exhaustion, of raw material in a manufacturing process. The terms 'depletion' and 'depreciation' are mutually exclusive; together they are the equivalent of the phrase 'exhaustion, wear, and tear'; in the case of an oil well, however, the exhaustion is described as depletion. In view of the particular language of section 234 (a) (8) relating to oil and gas wells, I think exhaustion was intended to be included in the depletion allowance of 27½ per cent of the gross income from the property during the taxable year, and only compensation for wear and tear of physical property allowed in addition thereto."

The same idea was discussed to some extent in the decision by the Circuit Court of Appeals in *Burnet* v. *Petroleum Exploration*, 61 Fed. (2d) 273, 276.

This theory is erroneous. It is inconsistent with the action by the Government and the court with respect to other elements in this case.

The Government at first held that the costs for the freight on the materials and equipment and the hauling of same to the site of the oil well must be recovered through depletion and not through depreciation. However, it conceded in the Court of Claims that depreciation should be allowed upon these costs. The dissenting opinion agrees that this is a proper item for depreciation (R. 14), and the Circuit Court of Appeals in the *Petroleum Exploration* case also agrees to this (61 Fed. (2d) 273, 277). Certainly it can not be said that this freight and hauling or the expenditures for the same are subject to wear and tear. The useful life or usefulness of same of course becomes exhausted. These items or expenditures can not be removed and used elsewhere. They have no salvage value. They have a value

and usefulness only connected with the one oil well. When the oil in that well is exhausted, these expenditures become absolutely worthless. They are as closely connected with the life of the reserve as the usefulness of the hole in the ground. What has been said above also applies with equal force to the cost of installing the equipment. Yet the Government now concedes and all agree that these costs shall be made the subject of depreciation. These installation costs include many items. It is a matter of common knowledge that engines must be used to pump the wells. These engines are mounted or set on heavy concrete bases and holes are dug into the ground in which to make foundations for these bases. There is no wear and tear on these holes in the ground for the foundations, or the foundations themselves or the concrete bases. They can not be moved or salvaged. The usefulness of these things and the value of the expenditures for the same are ended and destroyed when the oil ceases to exist in the well. Yet, as above stated, these costs are depreciated.

In reality the cost of drilling the hole in the ground may be properly considered a part of the cost of the installation of the materials and equipment and all now agree these costs should be depreciated. The drilling of the hole is nothing more than the construction of the receptacle for the casings and other materials and equipment. Without the hole the casing could not be installed.

The argument of the Government and the dissenting opinion in the Court of Claims would limit depreciation to the cost of articles which wear out and include in depletion the deductions because of the lessening of value of the mineral deposit and the lessening of value of investments for things which do not wear out but whose useful life is shortened as the mineral deposit becomes exhausted. It is said in this dissenting opinion, "The costs which may be included in the amount to be used for the purpose of computing the allowance for depreciation must be costs in relation to physical property which is subject to depreciation through wear and tear as distinguished through exhaustion. The deduction for depletion is a special applica-

tion of the general rule allowing a deduction for exhaustion. The depreciation charge represents the reduction during the year of the capital assets through wear and tear of the plant used. The depletion is likened to the using up, i. e., exhaustion of raw material in a manufacturing process. The terms 'depletion' and 'depreciation' are mutually exclusive; together they are the equivalent of the phrase 'exhaustion, wear and tear.' " In other words, this theory would allow depreciation upon only those things which are subject to wear and tear and would include in depletion everything whether it was an actual exhaustion of the natural deposit or only a wearing out or exhaustion of the useful life of the property simply because its value became lessened because of the exhaustion of the natural deposit upon the existence of which the usefulness of the investment depended.

It is apparent that Congress had no such an idea in mind and did not consider all forms of exhaustion as included in the term depletion. In Sec. 204 (c) of the Revenue Act of 1926, Congress said: "The basis upon which depletion, exhaustion, wear and tear and obsolesence are to be allowed," etc. It can not be said that the phrase "exhaustion" is surplusage and meaningless, yet that would be the effect if the term depletion included the allowances for the lessening in value of the useful life of investments.

The term depletion is used nowhere in the statute except with reference to "mines, oil and gas wells, other natural deposits, and timber." In all other properties exhaustion, wear and tear and obsolescence are all covered by the allowances for depreciation.

Sec. 214 (a) (8) expressly requires the deduction of "a reasonable allowance for exhaustion, wear and tear of property used in trade and business, including a reasonable allowance of obsolescence." Article 161 of Regulations 69 quotes this section of the statute under the heading "Depreciation" and says:

"A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or

business may be deducted from gross income. For convenience, such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with Section 204 and Articles 1591–1603."

In this general regulation applicable to all industries, exhaustion of the useful life was expressly included in the term depreciation whether such exhaustion resulted from wear and tear or otherwise. This regulation had been in existence for many years.

Article 162, headed "Depreciable property," says:

"The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art * * *. It does not apply to bodies of minerals which through this process of removal suffer depletion, other provisions for this being made in the statute * * *."

Article 163 headed "Depreciation of intangible propety" says:

"Intangibles, the use of which in trade or business is definitely limited in duration, may be the subject of a depreciation allowance."

Article 164 says:

"The capital sum to be replaced by depreciation allow-

ances is the cost or other basis of the property in respect of which the allowance is made."

Article 165 says:

"The capital sum to be replaced should be charged off over the useful life of the property * * *."

In dealing with timber properties, Article 232, headed "Depreciation of improvements in the case of timber," says:

"The cost or value as of the basic date, as the case may be, of development not represented by physical property having an inventory value shall be recoverable through depreciation."

It then provides that such costs may be recovered upon a unit of production basis. This does not exclude properties except those which are subject to wear and tear. It includes in depreciation such costs as are exhausted only because of the ending of the useful life of the property. It includes such costs as skidways, temporary roadways which will have no value except in connection with the timber and the life of the timber supply upon the tract or area.

All of the above clearly shows that the regulations did not confine depreciation to those things which were subject to wear and tear. As heretofore shown, *Article 225 of Regulations clearly provides for depreciation upon a unit of production basis and a unit of production basis is wholly inconsistent with confining depreciation allowances to wear and tear.*

It is respectfully submitted that the completed oil well is an improvement as the term is used in the statute, and a physical property as the term is used in the regulations, and that an allowance for depreciation should be made for all of the expenditures in the construction of such completed oil well. It is therefore submitted that not only the statute but also a proper construction of the regulations require the allowance of such a deduction, and that the action by the Commissioner in denying a deduction upon the cost of drilling a hole is inconsistent both with the statute and with the regulations.

II. *If the Regulations do not Require or Permit a Depreciation of the Drilling Costs, these Regulations are Contrary to the Statute and are Invalid.*

While we feel confident that the regulations of the Commissioner not only permit but require the depreciation of these so-called drilling costs, yet we submit that if these regulations neither require nor permit the same to be done, the regulations are in conflict with the express provisions of the statute and are, therefore, beyond the power of the Commissioner and are invalid.

We have heretofore shown that the statute (Section 234 (a) (8) specifically provides that in the case of oil and gas wells there should be made "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case"; we have also shown that the words depreciation and depletion are separate and distinct and have well defined meanings. This principle was recognized and announced by the decision of the Supreme Court in the case of *Ludey* v. *United States*, 274 U. S. 295. In view of the fact that some of the earlier Revenue Acts did not contain provisions for depletion and that such conditions resulted in an injustice, and that the later Revenue Acts contained specific provisions for depletion and also provided for depreciation (see *Ludey* case at p. 302), it can not be seriously contended that Congress in any manner confused the two terms.

In considering this question, we should also bear in mind the rules of statutory construction to the effect that the primary rule is to ascertain and give effect to the intent of the legislative body, and that where the language of a statute is plain and unambiguous and conveys a clear and definite meaning, resort must not be had to rules of construction but the statute must be given its plain and obvious meaning (*United States* v. *Missouri Pacific R. Co.*, 278 U. S. 269). Courts will not legislate but will construe the statutes as framed by Congress. The words will be considered as used in their ordinary sense and the literal meaning of a statute will not be departed from by the courts unless a literal con-

struction produces an absurdity so gross as to shock the general moral and common sense (*Crooks* v. *Harrelson*, 282 U. S. 55).

In dealing with taxing statutes, the general rule requiring adherence to the letter of a statute applies with peculiar strictness. See *Crooks* v. *Harrelson*, *supra*, p. 61.

In the case of *United States* v. *Merriam*, 263 U. S. 179, 187–188, the court said that in statutes levying taxes the literal meaning of the words employed is most important and such statutes are not to be extended by implication beyond the clear import of the language used.

Where, however, the language of a statute is of doubtful meaning, of course the court must construe the ambiguity, but in construing such ambiguity in a tax statute the same must be resolved in favor of the taxpayer and a taxing statute should not be extended by implication beyond the clear import of the language used (*Gould* v. *Gould*, 245 U. S. 151; *United States* v. *Merriam*, 263 U. S. 179, *Reinecke* v. *Trust Company*, 278 U. S. 339).

It is also a well settled rule that the Secretary of the Treasury can not by regulations alter or amend a revenue law (*Morrill* v. *Jones*, 106 U. S. 466), and while the regulations made by the Commissioner have the force and effect of statutes if made with the approval of the Secretary of the Treasury and pursuant to statutory authority, yet, if they are not reasonable or are in conflict with the statute, the regulations are invalid (*Burnet* v. *Moore Cotton Mills Company* (C. C. A. 4th), 49 Fed. (2) 59; *Palmer, Trustee*, v. *United States*, 67 C. Cls. 648 at 653, 654).

We respectfully urge that the statute says that both depreciation and depletion shall be allowed. Depreciation has the well established meaning of being the lessening in value of the improvements upon a property, while depletion has the well recognized and established meaning of a diminution of the natural deposits. Depletion of the natural deposits under this statute should not be confused with depreciation, and the depreciation of the improvements should not be confused with the depletion of the natural deposits. The statute is in the conjunctive and requires

that both should be allowed. See *Crooks* v. *Harrelson*, supra.

We have heretofore shown that these drilling costs become a part of the improvements put upon the property by man and are in no manner a part of the natural reserve or the mineral deposit. They are separate and distinct therefrom and any act of the Commissioner, whether by regulation or otherwise, that attempts to prevent the return of the investment in such improvements by way of depreciation is contrary to the statute and therefore under the decisions cited is invalid and must be ignored.

An examination of other provisions of Regulations 69 dealing with the question of depreciation and depletion conclusively shows that the Commissioner had in mind the distinction between depreciation and depletion and the reasons fundamental to each, and that if the regulations are not given the construction for which we have heretofore contended, it is submitted that they become unreasonable and inconsistent with each other as well as with the express provisions of the statute.

In Article 161, of Regulations 69, it is stated that:

"*Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with section 204 and articles 1591–1603. Due regard must also be given to expenditures for current upkeep." * * *

Article 162 provides that:

"*Depreciable property.*—The necessity for a depreciation allowance arises from the fact that certain property used in

the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the statute. (See sections 204 (c), 214 (a) (9), and 234 (a) (8) and articles 201–237 and 1602)." * * *

Article 163 provides that:

"*Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner."

Article 164 provides that:

"*Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See article 1602.)" * * *

Article 165 provides that:

"*Method of computing depreciation allowance.*—The capital sum to be replaced should be charged off over the useful life of the property, either in equal annual installments or in

accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable." * * *

Article 201 provides that:

"*Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions, * * * but not including land values for purposes other than the extraction of minerals. * * *

"When used in these articles (201–237) covering depletion and depreciation—* * *

"(c) A 'mineral property' is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface only as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The value of a mineral deposit is the value of the mineral property, less the value of the plant and equipment, and less the value of the surface of the land for purposes other than mineral production. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

"(e) 'Minerals' include ores of the metals, coal, oil, gas. * * *

"(g) 'Depletion or depreciation sustained' means (except in cases where a discovery value has been established, as to which see (h) below) depletion or depreciation actually sustained, whether legally allowable or not, based on the cost or value as at the basic date, as the case may be."

Article 203 provides that:

"*Amount returnable through depletion and depreciation deductions in the case of lessee.*—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computations of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property."

Article 207 provides the method for the determination of the fair market value of oil and gas properties, and, among other things, provides that:

"* * * The development cost includes expenditures for drilling wells to maintain or increase production or to develop additional unproven areas, and the cost of improvements necessary to the development of the property, such as roads, warehouses, water lines, etc. The operating cost includes all current expenditures for producing, preparing, and marketing the oil and/or gas produced, such as pumping oil wells, repairs of oil or gas wells, cleaning sanded wells, shooting wells, re-drilling old wells, labor and supplies for collecting oil, repairs to separators, pumps, and collecting lines, repairs to buildings and structures, repairs to field tools, equipment, fixtures and machinery, superintendence, other field expenditures, overhead, etc. (due consideration being given to taxes), exclusive of allowable capital additions

as defined in article 223 and deductions for depreciation and depletion. The cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returnable to the taxpayer free from tax." * * *

From the above it will be seen that the Commissioner of Internal Revenue has recognized the distinction between depreciation and depletion. He has also recognized the fundamental basis of the theory of depreciation and has specifically said in Article 162 that it does not apply to bodies of minerals which through the process of removal suffer depletion. He has also said (see articles 164 and 165) that it is the intention to permit the return of the capital sum invested in property used in business and that this sum should be charged off over the useful life of the property either in equal annual installments or by an apportionment of the capital sum over the units of production.

In Article 201 he again expressly recognizes the distinction between depreciation and depletion where he says that in the case of mines, oil and gas wells, the taxpayers should be allowed as a deduction in computing net income "in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements." He then goes on and explains the theory that the depletion shall cover the mineral deposits.

It is respectfully submitted that if it should be held that under the provisions of Articles 221, 223 and 225 of Regulations 69 these costs can not be made the subject of depreciation, then these articles become inconsistent with the other articles of Regulations 69 which have just been discussed, and it is further submitted that Articles 221, 223 and 225 so construed become inconsistent with the express words of the statute which require the allowance of both depreciation and depletion and that such depreciation and depletion are separate and distinct and have been so recognized by the Commissioner of Internal Revenue in other articles of these same regulations.

It is manifest that Congress intended that the operation

of the provisions with reference to depreciation and depletion should permit the return of the capital investment of the taxpayer and the allowances for discovery value over the period of years of operation. It is equally manifest that an oil well as well as the investment therein will have no useful life after the oil in paying quantities has been exhausted. The arbitrary allowance for depletion is 27½ per cent of the gross income for the year. This bears absolutely no relation to the amount of money expended in the drilling of wells upon the property, but as the regulations of the Treasury Department will reveal, and as the statements by the courts in the decided cases will show, was an arbitrary figure which from experience was believed just and was arrived at in order to avoid the many difficulties in the ascertainment of depletion quantities and discovery values, but it was never meant to have any application to the recovery of the capital investment in the cost of the construction of oil wells and such operating properties.

It is clear that the statute expressly requires the allowance of a deduction for depreciation upon the entire cost of constructing a completed oil well, including the cost of drilling the hole and that if the regulations do not require or permit such deductions then they are inconsistent with other provisions of the same regulations, they are unreasonable and are contrary to the statute, and, therefore, must be disregarded.

III. *The decision by the Circuit Court of Appeals for the Fourth Circuit in the case of Burnet v. Petroleum Exploration.*

After stating some general principles of law the court at page 276 (61 Fed. (2d) 273) says that the taxpayer was given the option by Article 223 of Regulations 69 to charge the expenditures in question either to current expense or to charge them to capital account returnable through depletion, and the taxpayer having charged such expenditures to capital account with full knowledge that they would be returned only through depletion is bound by the election

so made and must accept the terms of the option. There are several answers to this theory which it is believed proves the theory to be unsound.

First. As has been heretofore set out in this brief, it is believed that a proper construction of the regulations themselves require the allowance of a depreciation upon the total cost (including the drilling costs) of a producing oil well. Also, such drilling costs are in reality only a part of the cost of placing casing and installing equipment which the Government admits are to be the subject of a depreciation.

Second. If the proper construction of the regulations does not permit a depreciation upon the costs in question then such regulations are in conflict with the statute and can not control since the statute requires the allowance of a depreciation upon these costs.

Third. Since the statute requires a deduction for depreciation upon these costs, the regulations can in no way limit the right to same or place conditions upon its allowance.

Fourth. The costs in question are in reality and in fact capital investments and the regulations can not change their character. These costs partake of the nature of permanent investments for permanent improvements, and are in fact capital investments. They should be charged to capital account. That they are not current expense has been decided by the Board of Tax Appeals in *Old Farmers Oil Co.* v. *Commissioner*, 12 B. T. A. 203; *Consolidated Mutual Oil Co.* v. *Commissioner*, 2 B. T. A. 1067, *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551, and *J. H. Hughes Oil Co.* v. *Bass, Collector*, decided December 13, 1932, by the Circuit Court of Appeals for the Fifth Circuit, and as yet reported only in Vol. III C. C. H. 1932 Tax Service, page 9476. When the taxpayer charged such costs to capital account, it merely did what was proper and required not only by

proper accounting but also by law, and the Commissioner had no right to impose any penalties or burdens upon the taxpayer for doing that which was proper and required by the law.

Fifth. There was really no option offered by the regulations. Proper accounting as well as the law required the taxpayer to charge those costs to capital account. Also, before the well was producing the taxpayer had no income from the well from which to deduct the costs as a current expense, and it may well be in many cases and especially in the case of the true pioneer whom the statute aimed to aid that he had no income from any source from which to deduct such costs as current expenses at the time such expenditures were made.

Sixth. There was in fact no advantage to the taxpayer in charging these costs to capital account instead of current expense. The real advantage accrued to those who were in position to charge such costs to current expense. Therefore when the taxpayer charged these costs to current expense and followed the only proper and legal course it made no election which placed upon it any penalties or burdens which it is now contended were imposed by the regulations. The taxpayer who charges such costs to current expense has at least two and probably more advantages over the taxpayer who follows the proper and legal course of charging such costs to capital account. (a) The taxpayer who charges the cost to current expense gets all of such costs returned at the time they are incurred and in one allowance while the taxpayer who charges the same to capital account gets such costs returned, if at all, over a long period of years. The immediate return of all is certainly more desirable than the possible return of all in deferred installments. (b) The taxpayer who charges such costs to capital account runs the risk of an inaccurate estimate of reserves preventing the return of all such costs whether returned through depreciation or depletion. The taxpayer who gets the im-

mediate return of such costs as current expense runs no such risks.

Therefore, when the taxpayer merely does the proper and legal thing by charging to capital account costs which are in fact capital investments, it only exercises and stands upon its rights under the law and does not exercise any election to accept an option thereby incurring the penalties or burdens now contended for by the Government. Such penalties and burdens are not imposed by the law and the taxpayer is free to stand and insist upon all of its rights.

The contention of the Government that such costs can be recovered only through depletion is unreasonable and would result in a discrimination in favor of those who charge off such costs as current expense. The following tabulation using a hypothetical case shows the disadvantage to the taxpayer who does the legal thing and charges such costs to capital account but who is compelled by the Treasury Department to attempt to recover same by depletion allowances. This computation is not for a single year but is based upon the total life of the oil well. For this purpose it is assumed that:

Lease Cost	$100,000.00
Oil Sales	1,000,000.00
Production Expense, etc.	100,000.00
Well Cost:	
Equipment (Assumed no salvage value)	150,000.00
Intangible Drilling Cost	150,000.00

Taxable Income Under 1926 Act.

		Drilling Cost Capitalized	
	Drilling Cost Charged off as expense	*Restored through Depreciation*	*Restored through Depletion*
Gross Income	$1,000,000.00	$1,000.000.00	$1,000.000.00
Deduct:			
Production Expense, etc.	100,000.00	100,000.00	100,000.00
Drilling Cost Charged off as expense	150,000.00	None because capitalized	None because capitalized
Depreciation:			
Of Equipment	150,000.00	150,000.00	150,000.00
Of Drilling Cost	None because Charged Off	150,000.00	None because included with depletion
Total Deductions	$400,000.00	$400,000.00	$250,000.00
Net Income—before depletion	$600,000.00	$600,000.00	$750,000.00
27½% of Gross Income	$275,000.00	$275,000.00	$275,000.00
50% of Net Income before depletion	$300,000.00	$300,000.00	$375,000.00
Statutory Depletion Allowance, 27½% Gross income or 50% net income whichever is smaller	$275,000.00	$275,000.00	$275,000.00
The Statutory Depletion Allowance Comprises:			
Return of Lease Cost	$100,000.00	$100,000.00	$100,000.00
Return of Capitalized Drilling Cost	None because charged off	None because returned thru depreciation	150,000.00
Allowance in excess of amount needed to return capital invested	175,000.00	175,000.00	25,000.00
Total	$275,000.00	$275,000.00	$275,000.00
Net Income before Depletion shown above	$600,000.00	$600,000.00	$750,000.00
Statutory Depletion Allowance	275,000.00	275,000.00	275,000.00
Taxable Net Income	$325,000.00	$325,000.00	$475,000.00

It is thus seen that the taxpayer who charges off such costs as expense or who recovers the costs by depreciation gets a discovery value return of $175,000 and pays tax on a net income of only $325,000 from the well, while the taxpayer

who relies on depletion allowance for the recovery of such costs gets a discovery value return of only $25,000 and has to pay tax upon a net income of $475,000 from the same well. In the hypothetical case used, the 27½% flat statutory allowance is greater than the depletion based upon actual cost; therefore, no advantage would be gained by taking the depletion upon the basis of costs. But even if the depletion based upon cost is greater than the flat rate of 27½%, still the taxpayer who charges off the costs as a current expense would have the advantage over the taxpayer who seeks to recover it through depletion.

This establishes that the real advantage of any alleged option is to those who charge off such costs as expense, also, that the contention of the Government renders the regulations unreasonable and discriminatory and that such contention is therefore unsound.

The Court of Appeals says: "It is true that Article 225 of Regulations 69 permits an allowance for depreciation of physical property but only so far as not to conflict with the option exercised by the taxpayer as to charging such expenditures to capital account, and such allowance is given only for such physical property as 'machinery, tools, equipment, pipes, etc.' " It is not believed that Article 225 imposes any burden or penalty upon the taxpayer or was intended to deprive it of its right to question the action of the Government in the determination of depreciation allowances. The words "so far as not in conflict with the option exercised by the taxpayer" under Article 223 can properly have but one meaning and that is that when the taxpayer exercises the "option" to charge the costs as current expense and not follow the proper and legal course of charging them to capital account then of course the taxpayer having received a return as expense of all of his costs for the well can not be allowed another deduction, and the additional allowance of more than such costs by way of depreciation. In other words, having already received a return of all costs the taxpayer will not be allowed more. Of course the taxpayer will also receive the flat rate allowance for depletion.

The Circuit Court of Appeals then concludes that the hole of an oil well is not physical property; that it is not an improvement; that it does not deteriorate or depreciate as does a piece of machinery; that when the mineral is exhausted the hole is useless and of no value, and that therefore the proper and logical method of returning the cost of drilling the hole is through depletion rather than depreciation. It is believed that what we have previously said in this brief proves that these conclusions by the court are unsound and such arguments need not be repeated here.

The Circuit Court of Appeals then says that if the cost of the hole is included in depreciation allowances as well as cost of machinery, tools, etc., then there is no expense whatever connected with an oil well left to be returned through depletion and the regulation (Article 223) is robbed of any meaning except as to exploration of the property. Here the court fails to take into consideration the cost of the land or lease which in addition to exploration costs are left to depletion and also fails to take into consideration the discovery value which did not represent actual expenditures, but which was intended to be cared for by the 27½% depletion allowance.

The Circuit Court of Appeals then holds that the construction contended for by the Government had been followed for a long time and had the implied approval by Congress and that the long continued and consistent administrative construction which has had the implied approval by Congress should not be disturbed.

It is believed that this holding is erroneous and is not supported by the facts or the law.

As has heretofore been set out, a proper construction of the regulations requires the allowance of depreciation as contended for by respondent. Even if the regulations do not require such allowance the statute does require it and any regulations to the contrary are invalid. It is clear that the regulations can not overcome the statute. If the statute requires the allowance, there is no room for the application of the doctrine of long continued administrative construction.

There has been no long continued, consistent administrative construction. Before 1918 there was no depletion allowance. Between 1918 and 1924 the statutes permitted any proper amount as a depletion allowance. From 1924 to 1926 the statute permitted not to exceed 50% of net income as a depletion allowance. In 1926 the statute was materially changed and instead of the depletion allowance being based upon costs or discovery value it was determined by an arbitrary and flat allowance based upon gross income and having no real relation to cost. Before 1926 it made no real difference whether the drilling cost was received through depletion or depreciation since both were calculated upon a unit of production basis and upon cost plus a discovery value. After 1926 the method of receiving a return of the costs became very important. We are here concerned with the tax for the year 1926, the very first year in which the Revenue Act of 1926, which made such radical changes, was in operation. In these circumstances it can hardly be said that there was a long continued, consistent administrative construction or that Congress had approved same.

Further than this, it has been heretofore shown that any taxpayer and Congress was justified in believing that the regulations did require the allowance of depreciation as respondent contends, and if such regulations did not permit such allowance they were so uncertain and inconsistent with other provisions of the regulations as to render taxpayers and Congress unable to say what the regulations meant. It is respectfully submitted that any developer of oil wells as well as Congress was entirely justified in believing that when the regulations required a depreciation upon physical properties it included a completed oil well and did not require the arbitrary segregation of the costs into classes created by resort to unreasonable requirements and refinements.

An examination of Regulations 45 under the Revenue Act of 1918, Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924, and Regulations 69 under the Revenue Act of 1926, reveals that there was not in fact a long standing, consistent, and definite interpretation by the Treasury Department upon the ques-

tion of depletion and depreciation in oil and gas wells. The very fact that in the Revenue Act of 1926 a flat deduction of 27½ per cent of gross income was substituted as the allowance for depletion in lieu of the former allowance based upon a discovery value and a unit of production basis shows that there could have been no consistent action upon this question prior to the Revenue Act of 1926 which was applicable to that act. Regulations 45 issued under the Revenue Act of 1918 are so entirely different that an effort to compare them with the later regulations seems futile. Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924, and Regulations 69 under the Revenue Act of 1926 are all somewhat similar upon the questions of depreciation and depletion of mining oil and gas properties. These regulations are found in Articles 201 to 226 both inclusive of the respective regulations. It will be noted, however, that in Articles 202, 203, and 204 of Regulations 69 under the Revenue Act of 1926 the following sentence appears which does not occur in any of the prior regulations: "The provisions of this paragraph do not apply to the computation of the depletion allowance in the case of oil and gas wells when such allowance is based on income from the property." Article 214 of Regulations 69 specifically provides that if by reason of the youth of the field or for any other cause it is not possible to determine with any degree of certainty the quantity of oil or gas on the property "the deduction for depletion shall be based upon the income from the property." The quoted portion does not appear in prior regulations, but other provisions are made. The title of Article 215 is changed in Regulations 69 so as to exclude from its provisions depletion based upon income, and the last sentence of the article provides that if the deduction is computed on the basis of income we should see Article 221.

Paragraph (e) of Article 216 of Regulations 69 is new and is made necessary because of the application of the flat rate of deduction for depletion, and the last sentence in that Article also refers to Article 221 for depletion on oil and

gas wells. Article 221 of Regulations 69, providing for depletion of oil and gas wells, is new and reads as follows:

"Art. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

All of the above clearly shows that there was such a change in the Revenue Act of 1926 in dealing with depreciation and depletion in oil wells that it can not be said that the prior regulations constitute a long-standing, administrative interpretation of the Revenue Act of 1926 or an implied approval thereof by Congress.

Petitioner has attached as a part of Appendix A to its brief herein (p. 25 to 29) Treasury decision No. 4333. This should have no bearing upon the case. It is dated April 11, 1932. The petition was filed in the Court of Claims on October 9, 1930. The claimant's brief was filed in that court on January 13, 1932, and the Government's brief on April 7, 1932. It thus appears that the Treasury decision is in the nature of a self-serving statement issued by the Government just after the Treasury Department had prepared its brief in this case. The decision is also directly opposed to the prior decisions of the Board of Tax Appeals in four different cases, namely, *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551; *Petroleum Exploration* v. *Commissioner*, 23 B. T. A. 890; *Ziegler, et al.* v. *Commissioner*, 23 B. T. A. 1091; and *P. M. K. Petroleum Co.* v. *Commissioner*, 24 B. T. A. 360. Since this Treasury decision is an attempt to explain the regulations and the alleged prior administrative action which it is stated is of long standing, it

constitutes an admission that the prior regulations and alleged administrative action are not clear or understood and need explanation even to the various Collectors of Internal Revenue to whom it is in part addressed. It should be noted in this connection that the Board of Tax Appeals, which certainly is familiar with tax matters and the interpretation of tax statutes and regulations, had then held that under the regulations the costs involved in this case were subject to depreciation (see *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551). But even if we examine the contents of the Treasury decision we find that it is so uncertain, indefinite, inconsistent, and confusing as to not convey a definite idea to any one upon the matters involved in this case. For example, on page 26, it is stated that the option to charge to current expense or to capital account applies to "hauling and supplies." On page 27, the decision says: "In general, this option applies only to expenditures for those drilling and development items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value even though used in connection with the installation of physical property which has a salvage value." Yet, on page 28, it is stated that if the taxpayer charges such costs to capital account "in so far as they are not represented by physical property," they are returnable through depletion, and that if such expenditures are charged to capital account in so far as represented by physical property they are returnable through depreciation, such expenditures so subject to depreciation "are, amounts paid for wages, fuel, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks or other physical structures."

In the face of this confusion, can it properly be said that Congress approved the alleged administrative interpretation of the statutes and the regulations or that Congress or any one else even understood what was the alleged administrative action. Certainly they can not be used to overcome the positive and mandatory provisions of the statute.

CONCLUSION.

For the reasons heretofore stated it is respectfully submitted that the decision by the Court of Claims should be affirmed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

No. 434.—October Term, 1932.

The United States, Petitioner, *vs.* Dakota-Montana Oil Company. } On Writ of Certiorari to the Court of Claims.

[March 13, 1933.]

Mr. Justice Stone delivered the opinion of the Court.

Respondent, a North Dakota corporation, in making its tax return of income derived from its operation of oil wells in 1926, claimed a deduction from gross income of a depreciation allowance on account of the capitalized costs of preliminary development and drilling. The Commissioner refused to allow the deduction claimed, ruling that it was for depletion, not depreciation, and was therefore included in the statutory depletion allowance of 27½% of the gross income, which the respondent had also deducted. §§ 204 (c), 234 (a) (8), Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 41. Having paid the correspondingly increased tax, respondent brought this suit in the Court of Claims to recover the excess. The court gave judgment for respondent, holding that the development and drilling costs were the proper subjects of a depreciation allowance which should have been made in addition to that for depletion. 59 F. (2d) 853. This Court granted certiorari to resolve a conflict of the decision below with that of the Circuit Court of Appeals for the Fourth Circuit in *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273.

The Revenue Act of 1926, like earlier acts,[1] provided generally that "in the case of . . . oil and gas wells", taxpayers should be allowed, as a deduction from gross income, "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case"; such allowance "in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." [§ 234 (a) (8).] The earlier acts provided that depletion should

[1] § 234 (a) (9), Revenue Act of 1918; § 234 (a) (9), Revenue Act of 1921; § 234 (a) (8), Revenue Act of 1924.

be allowed on the basis of cost unless the taxpayer was the discoverer of the well upon an unproven tract, in which case the basis was the "value of the property" at the time of the discovery or within 30 days thereafter.[2] See No. 215, *Palmer* v. *Bender*, decided January 9, 1933. But the "discovery value" provision was eliminated from the Act of 1926, which is applicable here, and the taxpayer was permitted to calculate depletion on the basis of cost alone [§ 204 (c)] or else to deduct an arbitrary allowance, fixed by the statute, without reference to cost or discovery value, at 27½% of gross income from the well.[3]

Articles 223 and 225 of Treasury Regulations 69, under the Revenue Act of 1926, were followed by the Commissioner in assessing the present tax. Article 223 purports to permit the taxpayer to choose whether to deduct costs of development and drilling as a development expense in the year in which they occur or else to charge them "to capital account returnable through depletion". In the latter event, which is the case here, "in so far as such expense is represented by physical property, it may be taken into account in determining a reasonable allowance for depreciation" which, if the arbitrary deduction for depletion were claimed, would constitute an additional allowance. Article 225 limits the depreciation for which an allowance may be made to that of "physical property, such as machinery, tools, equipment, pipes, etc." We do not doubt that the effect of this language is to require the taxpayer to look to the depletion allowance, in this case 27½% of gross income, for a return of the costs of developing and drilling the well, which are involved here.

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[2] § 234(a) (9), Revenue Act of 1918; § 234 (a) (9), Revenue Act of 1921; § 204 (c), Revenue Act of 1924.

[3] "Sec. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

. . . . . .

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph. . . ."

Respondent challenges the validity of the regulations thus applied as in conflict with § 234 (a) (8), which allows the deduction of a reasonable allowance "for depreciation of improvements" in addition to the deduction for depletion. It is urged that the drill hole is an "improvement" of the taxpayer's oil land and that no logical distinction in accounting practice can be made between the cost of this improvement and the cost of buildings and machinery placed on the property for the operation of the well, for which depreciation should admittedly be allowed.

The government argues that the well itself is not tangible physical property which wears out with use so as properly to be the subject of depreciation, and that in any event the regulations are based upon the practices of the oil industry and are within the requirements of § 234 (a) (8) that a reasonable allowance for depletion and depreciation of improvements be made in all cases under rules and regulations to be prescribed by the Treasury Department.

We do not stop to inquire whether, under correct accounting practice, an anticipated loss of a part of the capitalized cost of developing and drilling an oil well because of decreased utility of the well would be described or treated differently than wear and tear of the machinery used in production, or whether an allowance for the former serves a purpose logically distinguishable from one for the latter. For the issue before us, whether the statute requires the former to be treated as depletion, is resolved by the history of the legislation and the administrative practice under it.

The Revenue Act of 1916 permitted the deduction of a reasonable allowance for the "exhaustion, wear and tear of property" used in a business or trade and in the case of oil and gas wells "a reasonable allowance for actual reduction in flow and production". [§ 12 (b) Second.] The regulations authorized the deduction of an annual allowance for "depreciation" and, in the case of oil and gas wells, for "depletion" (Treasury Regulations 33, Arts. 159, 160, 162, 170), but ruled that no annual deduction for "obsolescence" was authorized by the statute in any case; such a loss it was provided, might only be deducted in the year when it became complete by abandonment of the property as no longer useful. (See Arts. 162, 178, 179 of Treasury Regulations 33; *Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, 643.) In defining these terms, therefore, the Department was apparently faced with the prac-

tical consequence that no annual deduction could be made in anticipation of those losses which it regarded as attributable to obsolescence, while such a deduction might be made for those which it attributed to depreciation or depletion. Depreciation was defined generally to include the wear and tear and exhaustion of property by use, and obsolescence, the loss in value of property due to the fact that because of changing conditions it has ceased to be useful.

Plainly, under these definitions the loss in value of the drill hole for an oil well, because of the approaching exhaustion of the oil in the ground, was not to be treated as depreciation. Article 170 of Regulations 33 necessarily ruled that it was not to be treated as obsolescence by declaring that the purpose of the statutory provision relative to oil wells was to return, through the aggregate of annual depletion deductions, the taxpayer's capital investment in the oil, including "the cost of development (other than the cost of physical property incident to such development)". Article 170 thus contemplated that an annual deduction should be made for costs of development by including them in the cost of the oil in the ground for which a depletion allowance was authorized by § 12 (b), Second "for actual reduction in flow and production".

While the Revenue Acts which followed that of 1916 provided that taxpayers generally might deduct "a reasonable allowance for obsolescence" in addition to that "for the exhaustion, wear and tear of property used in the trade or business",[4] in each of them the section expressly applicable to oil and gas wells,[5] omitted the word obsolescence and provided, in terms, only for the deduction of an allowance for depletion and for depreciation of improvements. Whatever doubts this omission may have suggested as to the propriety of an allowance for obsolescence in the case of oil and gas wells, raising the same problem as that under the Act of 1916, the question whether an allowance should be made for development and drilling costs was set at rest, where cost was the basis of depletion and depreciation of improvements, by the express language of the Acts of 1918 and 1921, that the cost basis should include "costs of development not otherwise deducted". But the questions remained whether the allowance was to be treated as for

[4] § 234 (a) (7) of the Revenue Acts of 1918, 1921, 1924 and 1926.
[5] See note 1, *supra*.

depreciation or depletion, and more important, whether any allowance could be made for development costs when the basis of depletion was discovery value rather than cost.[6] In answering these questions the Department adhered to and made explicit the position taken by it under the 1916 Act that development costs other than the cost of physical property incident to the development must be returned through the depletion allowance, but the regulations also provided expressly that the cost of "physical property such as machinery, tools, equipment, pipes, etc.," should be returned by an annual allowance for depreciation. (Arts. 223, 225 of Treasury Regulations 45 under the Revenue Act of 1918.) The distinction thus taken was continued in the regulations under the Acts of 1921, 1924 and 1926,[7] although beginning with that of 1924 the express declaration of the statute, already noted, that the cost basis for depletion and depreciation of improvements should include costs of development was eliminated, leaving the broad provision that a reasonable allowance should in all cases be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.

Doubts arising because of the silence of the Revenue Acts of 1918 and later years as to whether costs of development and drilling were to be included in depletion when based on discovery value, were resolved by the regulations already noted and by the addition of another. Article 220 (a) (3) of Treasury Regulations 45 provided that "the 'property' which may be valued after discovery is the 'well'. For the purposes of these sections the 'well' is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of the particular sand, zone or reservoir . . . in which the discovery was made by the drilling, and from which the production is drawn". By including the drill hole in the property to be valued for depletion under § 234 (a) (9), this article necessarily carried forward the distinction taken under the 1916 Act between drilling costs, subject to

[6]The discoverer of an oil well upon an unproven tract was permitted, for the first time by § 234 (a) (9) of the Revenue Act of 1918, to calculate the allowance for depletion upon the basis of the value of the "property" at the time of the discovery or within thirty days thereafter. See note 2, *supra*. The statute was silent as to the inclusion of development costs.

[7]Arts. 223, 225, of Treasury Regulations 62, 69; Arts. 225, 227, of Treasury Regulations 65.

depletion allowance, and costs of machinery, tools and equipment, subject to allowance for depreciation. Sections 234 (a) (9) of the Revenue Act of 1921 and § 204 (c) of the Act of 1924 continued the provisions of the 1918 Act, and this regulation remained unchanged.[8] It was eliminated under the 1926 Act, being no longer necessary, as the statute omitted the "discovery value" provision and substituted the arbitrary percentage allowance for depletion.[9]

Thus the Acts of 1918, 1921 and 1924 were consistently construed by the regulations to permit a depletion, but not a depreciation allowance for the costs of development work and drilling, which were treated for this purpose either as a part of the cost or an addition to the discovery value of the oil in the ground. The administrative construction must be deemed to have received legislative approval by the reenactment of the statutory provision, without material change. No. 80, *Murphy Oil Co.* v. *Burnet*, decided December 5, 1932; *Brewster* v. *Gage*, 280 U. S. 327, 337.

Respondent argues that whatever effect may be attributed to earlier reenactments, that of 1926, which is applicable here, is without force because § 204 of that Act abandoned discovery value as the basis of depletion and permitted the taxpayer to abandon cost and substitute a fixed allowance of 27½% of gross income from the well. We think the contention unfounded and that, on the contrary, what was included in the reasonable allowance for depletion by the established construction of the earlier acts gave significant content to the word as used in the Act of 1926. There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not and that depletion includes under the 1926 Act precisely what it included under the earlier acts. The regulations under the 1926 Act so ruled, as has been shown, by continuing the provisions of earlier regulations under which costs of development and drilling were returnable by the depletion allowance and not by an additional allowance for depreciation.[10]

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[8]Arts. 220 (a) (3) of Treasury Regulations 62 and 222 (3) of Treasury Regulations 65.

[9]See Senate Report No. 52, 69th Congress, 1st Session, pp. 17, 18.

[10]Compare also Treasury Decision 4333, Internal Revenue Bulletin XI, April 11, 1932, No. 15, pp. 2, 3.

It is true that the Board of Tax Appeals in construing the 1924 and 1926 Acts has held that capitalized drilling costs are subject to a depreciation rather than a depletion allowance. *Jergins Trust Co.* v. *Commissioner*, 22 B. T. A. 551; *Ziegler* v. *Commissioner*, 23 B. T. A. 1091; *P. M. K. Petroleum Co.* v. *Commissioner*, 24 B. T. A. 360. But these cases were all decided after the enactment of the 1926 Act and did not consider the administrative and legislative history, which we think decisive.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

END OF CASE